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The editors welcome contributions to the Economic Perspectives section. Material submitted should be of interest to a predominately Scottish readership and written in a style intelligible to a non-specialist audience. Contributions should be submitted to Cliff Lockyer c.j.lockyer@strath.ac.uk

Articles accepted for publication should be supplied electronically and conform to the guidelines available from Isobel Sheppard fraser@strath.ac.uk

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Outlook and appraisal

Overview

The basic picture continues to be one of weak recovery with a further weakening apparent towards the end of 2011, as the UK economy contracted by 0.2%. Scottish GDP is still -3.3%% below the pre-recession peak nearly four years ago, while the figure for UK GVA is -3.6%. However, while the depth of the recession was greater in the UK, at -7.2%, than in Scotland, -5.9%, the recovery of UK GDP has been slightly faster than in Scotland. The National Institute in London has noted that the time taken in returning to the pre-recession peak is now greater than in the Great Depression in the 1930s. Our new forecast suggests that overall Scottish GDP will not return to its pre-recession peak - the level of GDP the economy was at just before it went into recession - until the third quarter of 2014, just in time for the Commonwealth Games in Glasgow (23rd July to 3rd August 2014). That is, six years after the recession began.

The labour market in Scotland is now clearly weaker than the UK. Recent employment losses have taken the Scottish jobs market to a position 3.9% below its pre-recession employment peak. This is not that much different from the trough of the recession after employment had fallen by -4.8%. The UK jobs market is in contrast creating net jobs, all be it slowly and at an insufficient rate to stop unemployment rising. The result is that employment in the UK is now only -1.38% below its pre-recession employment peak. Of course that in itself is nothing to be complacent about since recession in the UK labour market began four years ago. Moreover, the situation in the Scottish labour market is worse than that implied by the employment figures. This is because the supply of labour is rising as working population increases. An examination of the amount of jobs on offer compared to the available labour supply reveals that the situation is now identical to the trough of the

recession. Hence unemployment has been rising strongly recently to 231,247 or 8.6% and above the UK rate of 8.4%. The number unemployed is very close to number reached at the trough of the recession in May-July 2010 when unemployment reached 236,819. Within that total more than 100,000 young people are estimated to be unemployed. This is a personal and social tragedy, which on most people's values should produce the strongest policy response. Moreover, it is also an economic tragedy because of the risk that a generation of employees may lose, or fail to gain, key employment skills that would be of significant productive use to the economy. Potential output will fall.

On a brighter note, the weakening in growth in the economy towards the end of last year does not appear to be as bad as many feared. There are some indications that growth is beginning to pick up and after a weak first six months growth may pick up towards the end of the year. The rate of inflation is falling as last year's VAT increase falls out of the statistic and the rise in import prices especially commodities and energy costs have moderated. Although the recent rise again in the price of oil to above $120 per barrel, driven by events in Iran, leads one to be cautious about the prospect for a rapid fall in inflation. The mainstream view is that a lowering of the inflation rate back to target will give a relative boost to real incomes and so encourage a rise in household demand. But this view might be misplaced. If the pressing need of households is to pay down debt and present real incomes mean that there actual saving is below the precautionary saving desired to pay down debt. Then a rise in real income could lead to higher savings with little or no impact on household demand. Let us hope it is the former rather than the latter.

The situation in the Eurozone remains the 'elephant in the room' as regards future growth prospects but the problem has eased for two reasons. First, the agreement secured by EZ finance ministers on the much-postponed €130bn second bail-out for Greece. Secondly, the role the ECB has recently played in acting as *de facto* lender of last resort. By buying securities from EZ banks the banks have been able to use the increased liquidity to fund some of the debt of the peripheral sovereigns. These developments offer only temporary respite to the EZ balance of payments and debt crisis. But there is still a risk of a disorderly Greek default and exit from the EZ, which will put at risk some of the other sovereigns such as Portugal and Spain. Moreover, the balance of payments financing and adjustment issues have hardly been tackled even if some progress has been made on debt.

Against this back ground we have revised down our forecast of GDP growth for 2012 to 0.4% from 0.9%. But we expect growth to be a little stronger in 2013 at 1.7% instead of 1.6%. By 2014 we predict a stronger recovery with growth of 2.6% taking us back to that pre-recession GDP peak by the third quarter. We expect Scottish growth to continue to be weaker than the UK but growth in the two jurisdictions is now expected to be much closer together, in line with the evidence from the recovery to date.

For employment, our central forecast is for net jobs to fall by -1.8% in 2011, and by -0.7% in 2012, rising by 1.0% in 2013 and by 1.7% in 2014. The number of employee jobs in Scotland is forecast to decline during 2012 by just less than 16,000 jobs. Through 2013 and 2014 we forecast increases in employee jobs in our central forecast, with annual increases of over 23 thousand and 38 thousand respectively. There are job increases across all the main sectors. However, we forecast a “rebalancing” of employment within the service sectors towards non-public activities as fiscal consolidation continues. Construction employment is forecast to increase in 2013 and 2014 as spending on (private) investment projects returns with renewed confidence in the recovery.

Unemployment is forecast to continue to rise on both key measures this year. On the

Figure 1: Scottish and UK Quarterly GDP Growth

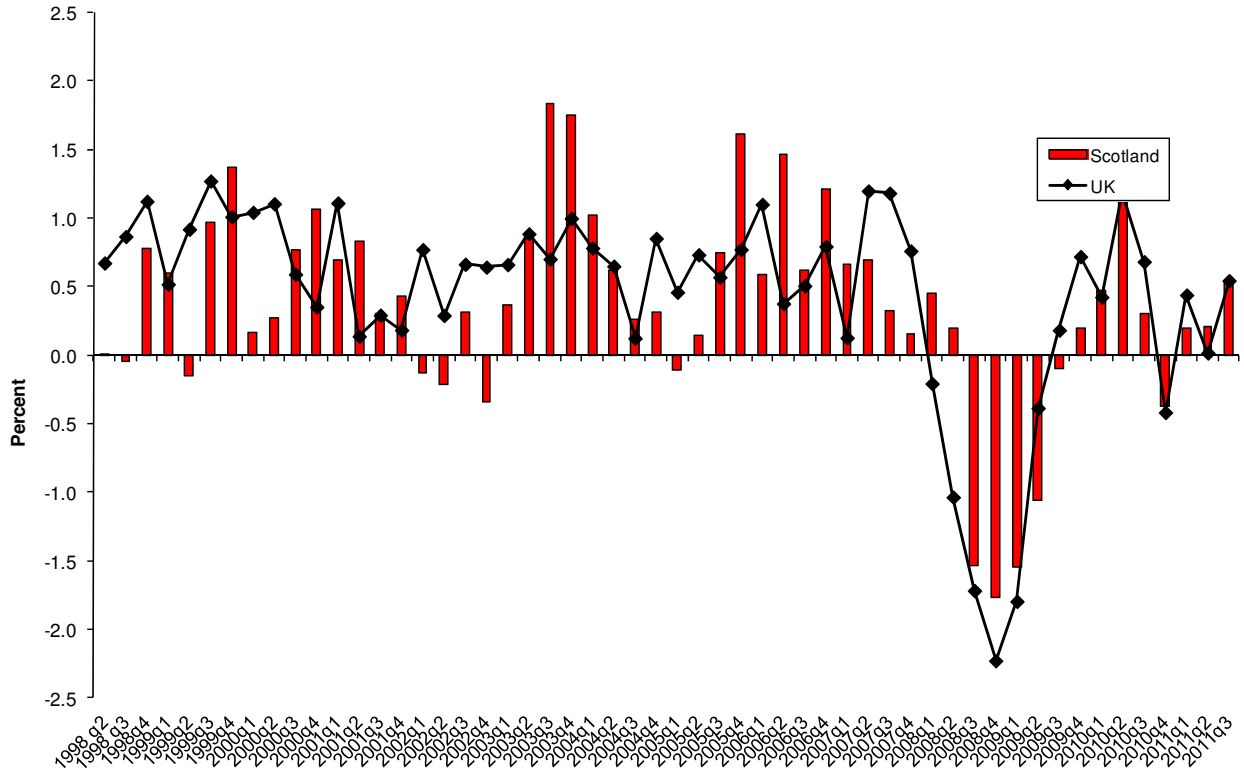
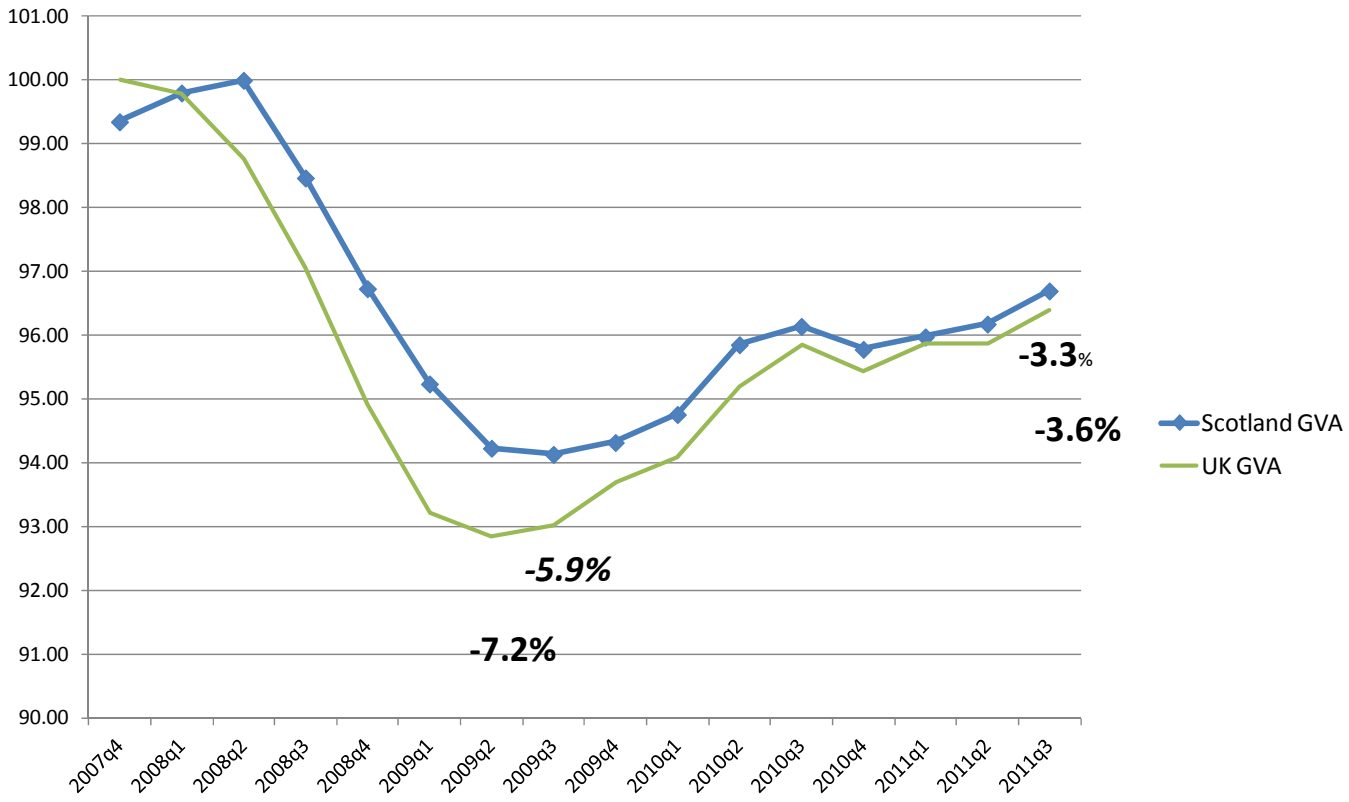


Figure 2: GVA in recession and recovery Scotland and UK to 2011q3 (Relative to pre-recession peak)



preferred ILO measure unemployment is predicted to reach 265,250 by the end of this year, or 9.8%. That is a rise of 34 thousand from the level reached at the end of 2011. As with our last forecast, we are expecting the unemployment position to improve through 2013, and are now forecasting unemployment at the end of that year of 253,950, 9.3%, falling further to 234,300, 8.8%, by the end of 2014.

Recent GDP performance

GDP grew by 0.5% in the third quarter identical to UK growth, compared to 0.2% in both the second and first quarters - see Figure 1. Over the year, GDP grew by less in Scotland, 0.9%, than in the UK 1.3%. It is also evident from Figure 1 that since the recession the Scottish economy has tracked the UK economy more closely than before.

While this rate of growth is close to the trend rate of growth it is weak for the recovery phase of the business cycle. It is suggested by the National Institute for Economic and Social Research (NIESR), through their Director Jonathan Portes, that the time taken in returning to the pre-recession peak is now greater than in the Great Depression in the 1930s.

Figure 2 shows that Scottish GVA now stands at -3.3% below the pre-recession peak nearly four years ago, while the figure for UK GVA is -3.6%. However, although the depth of the recession was greater in the UK, at -7.2%, than in Scotland, -5.9%, the recovery of UK GDP has been slightly faster than in Scotland.

At the broad sectoral level, services (0.9%) and manufacturing (0.6%) were the main drivers of third quarter growth. Indeed, the Scottish performance was stronger than in UK services (0.7%) and UK manufacturing (0.1%).

So, some comfort from a Scottish standpoint can be drawn from the latest data. But the performance of both services and manufacturing was weaker in Scotland over the year. The UK service sector grew by 1.2% over the year but Scottish services could only manage 0.3%. This underlines the weakness of the recovery in Scottish services, which is revealed in Figure 5.

Despite experiencing a smaller drop in output in the recession of -4.7% compared to a fall of -5.4% in the UK service sector, Scottish services GVA was still -2.8% below its pre-recession peak compared to -1.8% in the UK. Figure 6 charts recession and recovery in manufacturing. As with services the loss of output in recession was less than in the UK, but the recovery has been weak but comparable. GVA in manufacturing dropped by -10.1% in Scotland compared to -13.4% in the UK. In the most recent quarter manufacturing GVA in Scotland stood at -5.2% below its pre-recession peak compared to -7.3% in the UK. A driver of the recovery in manufacturing is exports, which appears to have faltered in 2011. Manufacturing exports grew by 0.2 per cent in real terms during the third quarter of 2011. But this represented a weaker performance than the second quarter, which in turn was weaker than the first quarter.

The construction sector was much weaker in Scotland in the third quarter contracting by -1.2% compared to an increase of 0.3% in the UK - see Figure 7. It is worth noting, though, that over the year the performance of Scottish construction was slightly better with growth of 5.9% compared to 5.4% in the UK. Figure 8 shows that the picture during the recession and recovery is more complicated. The drop in output in the recession was large and identical in Scotland and the UK at -18.3%. But Scottish construction bounced back more strongly than its UK counterpart, then contracted for 4 successive quarters, while UK construction contracted for 2 quarters and then grew over the last 2 quarters. The result was that by 2011q3, construction GVA in Scotland and the UK was broadly in the same place in relation to its pre-recession peak, at -6.9%.

Within services, the most important sector by contribution to GDP, business and financial services - 26% of overall GDP and 36% of service sector GVA - grew by 2.3% in Scotland and 1.2% in the UK during the latest quarter. However, over the year the sector contracted by -0.3% in Scotland but grew by 1.9% in the UK. Figure 9 shows the path of GVA in the sector during the recession and recovery relative to its pre-recession peak. What is clear from the chart is the greater recession in Scotland and weaker recovery. GVA fell by -7.0% in UK business and financial services during the recession whereas in Scotland the contraction was -9.8%. By the latest quarter the sector in the UK was -3.2% below its pre-recession peak while its Scottish counterpart was -6.5% below, which is not much different from the trough of the recession in the sector in the UK. Elsewhere in services Distribution, Hotels and Catering grew more quickly in Scotland in both the recent quarter and over the year. Growth was 0.7% in the quarter compared to 0.2% in the UK, while over the year the Scottish sector grew by 2.6% while its UK counterpart grew by 0.3%. In contrast, both Transport, Storage, Information & Communication and Government & Other Services grew more quickly in the UK. The Transport et al sector contracted by -0.3% in the quarter while the sector in the UK grew by 0.3%. Over the year, the sector contracted by -0.8% in Scotland while expanding by 1.3% in the UK. Similarly, in the government & other services sector growth was flat in the quarter but was positive at 0.6% in the UK. Over the year, the sector was largely stagnant in Scotland with growth of only 0.1% but exhibited growth of 1% in the UK. These slower rates of growth of government activity are likely in part to reflect the strengthening of the programme of fiscal consolidation.

For analysis of developments within manufacturing, we only have data on the Scottish economy. There are currently no UK figures on a directly comparable basis. That said, the

Figure 3: Scottish and UK Services GVA Growth at constant basic prices 1998q2 to 2011q3

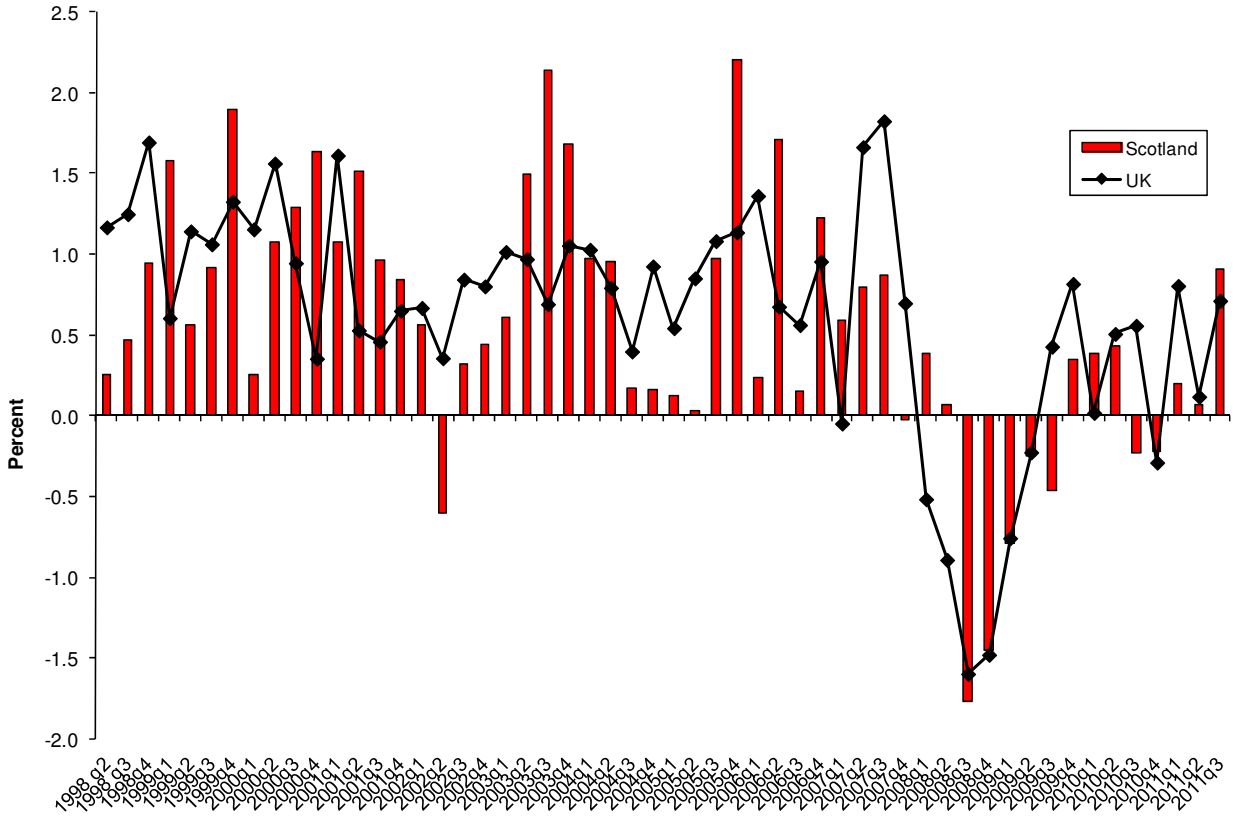


Figure 4: Scottish and UK Manufacturing GVA Growth at constant basic prices 1998q2 to 2011q3

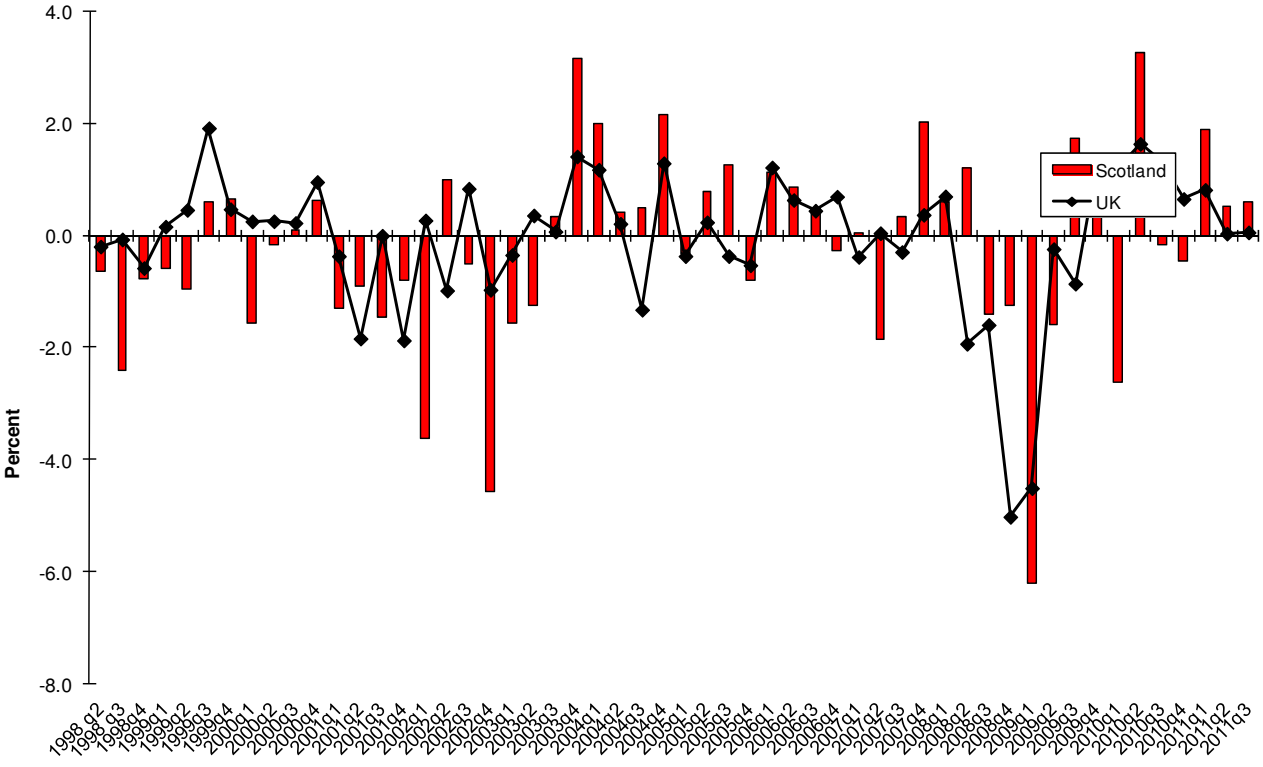


Figure 5: Services: Recession and Recovery to 2011q3

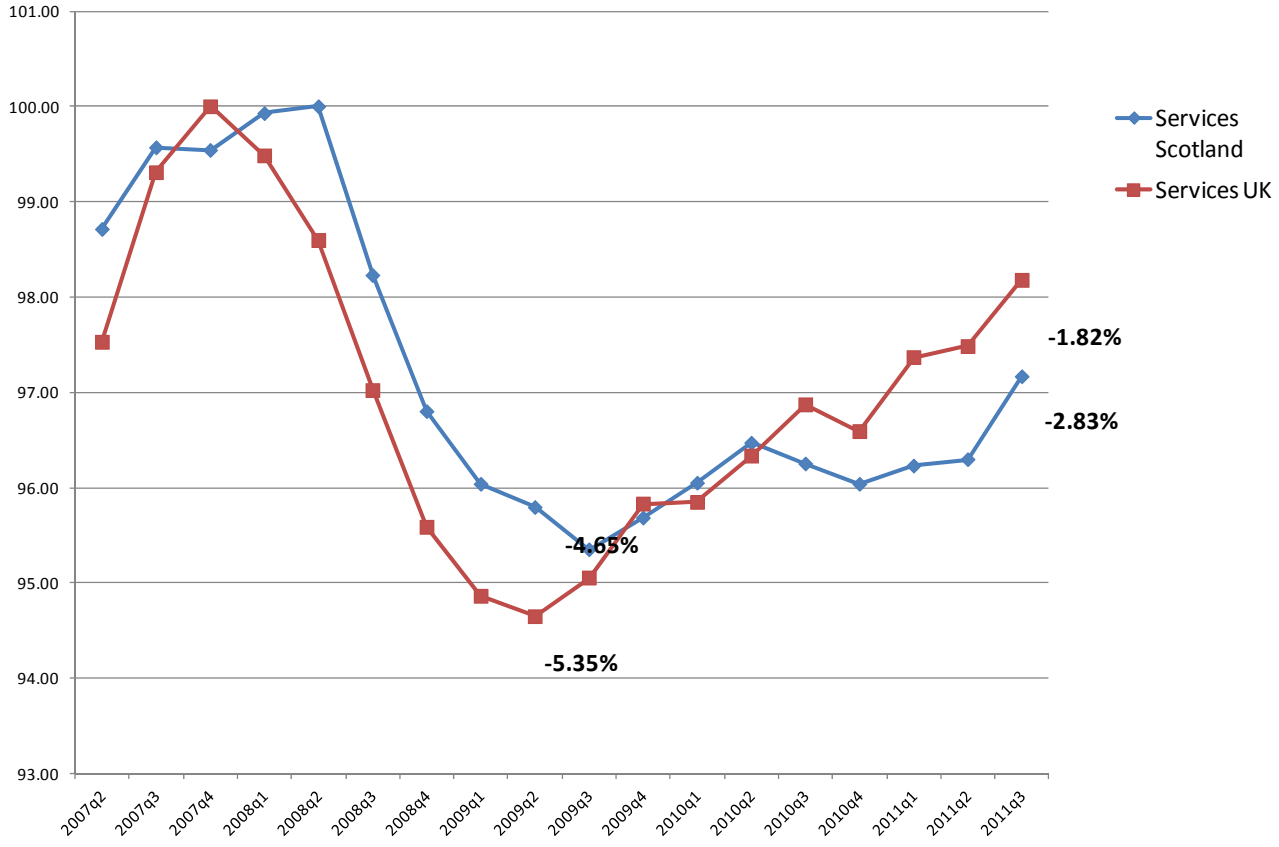


Figure 6: Manufacturing: Recession and Recovery to 2011q3

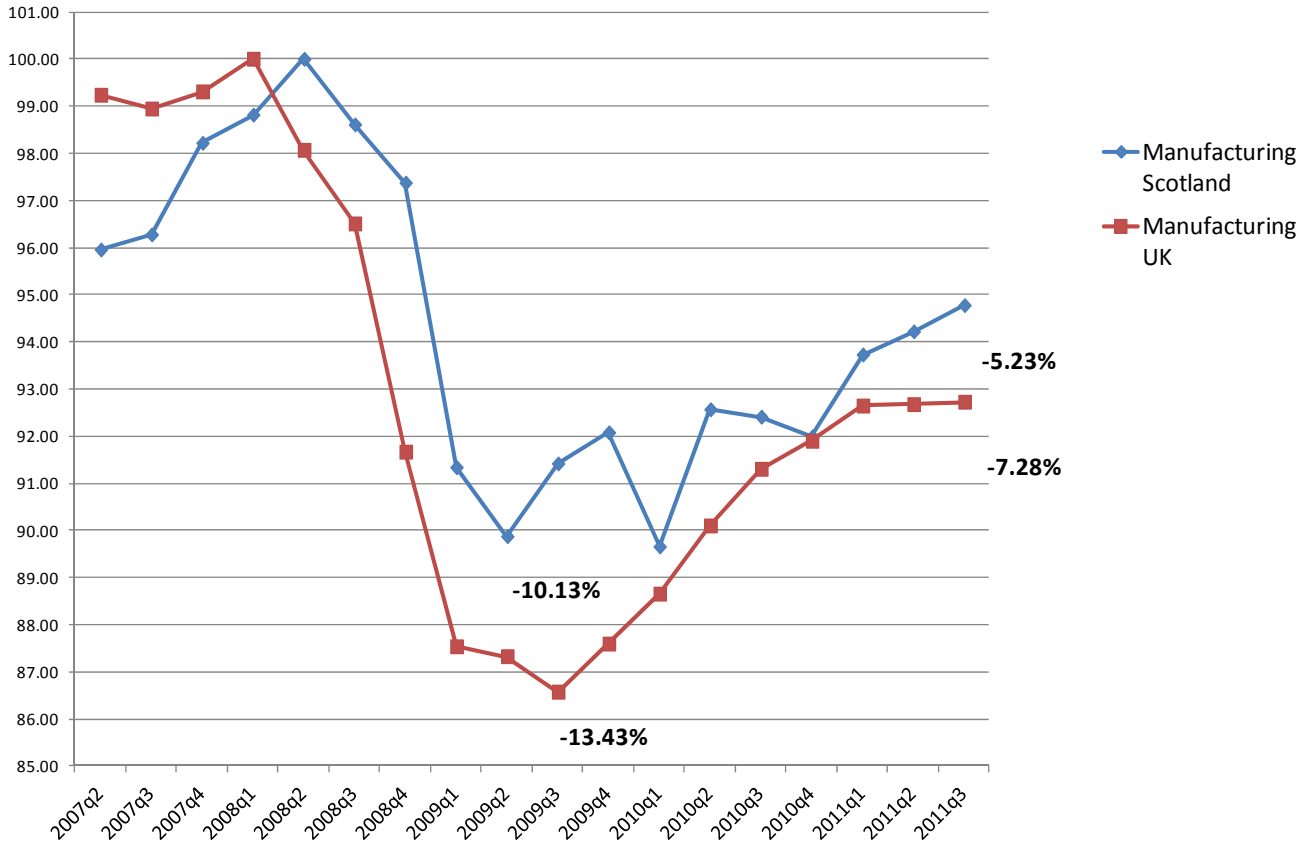
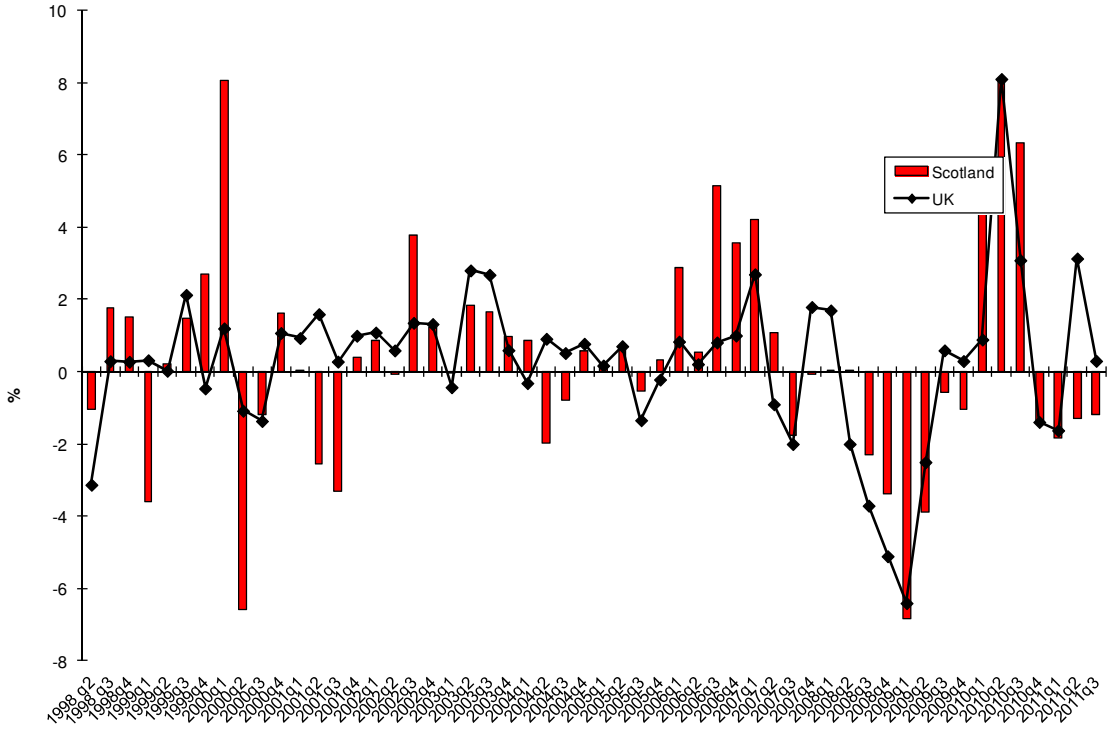


Figure 7: Scottish and UK Construction GVA Volume Growth 1998q2 - 2011q3



main sectors driving manufacturing growth of 0.9% in the third quarter were Engineering & Allied and Food & Drink, with growth of 1% and 1.9%, respectively. The Metals sector grew strongly with GVA rising by 3% during the quarter. However, metals accounts for half the weight of the other two sectors. Most of the main manufacturing sectors grew quite strongly over the year, which hopefully augurs well for future growth. Figure 10 shows the growth performance of manufacturing exports over the past eight years. The quarterly data are smoothed as a four-quarter moving average to remove some of the quarterly fluctuations to which the series is prone, in part because of the 'lumpy' nature of export orders and sales (The series is already seasonally adjusted.) Recovery from recession is clearly evident but the faltering nature of the recovery is also clear.

The labour market

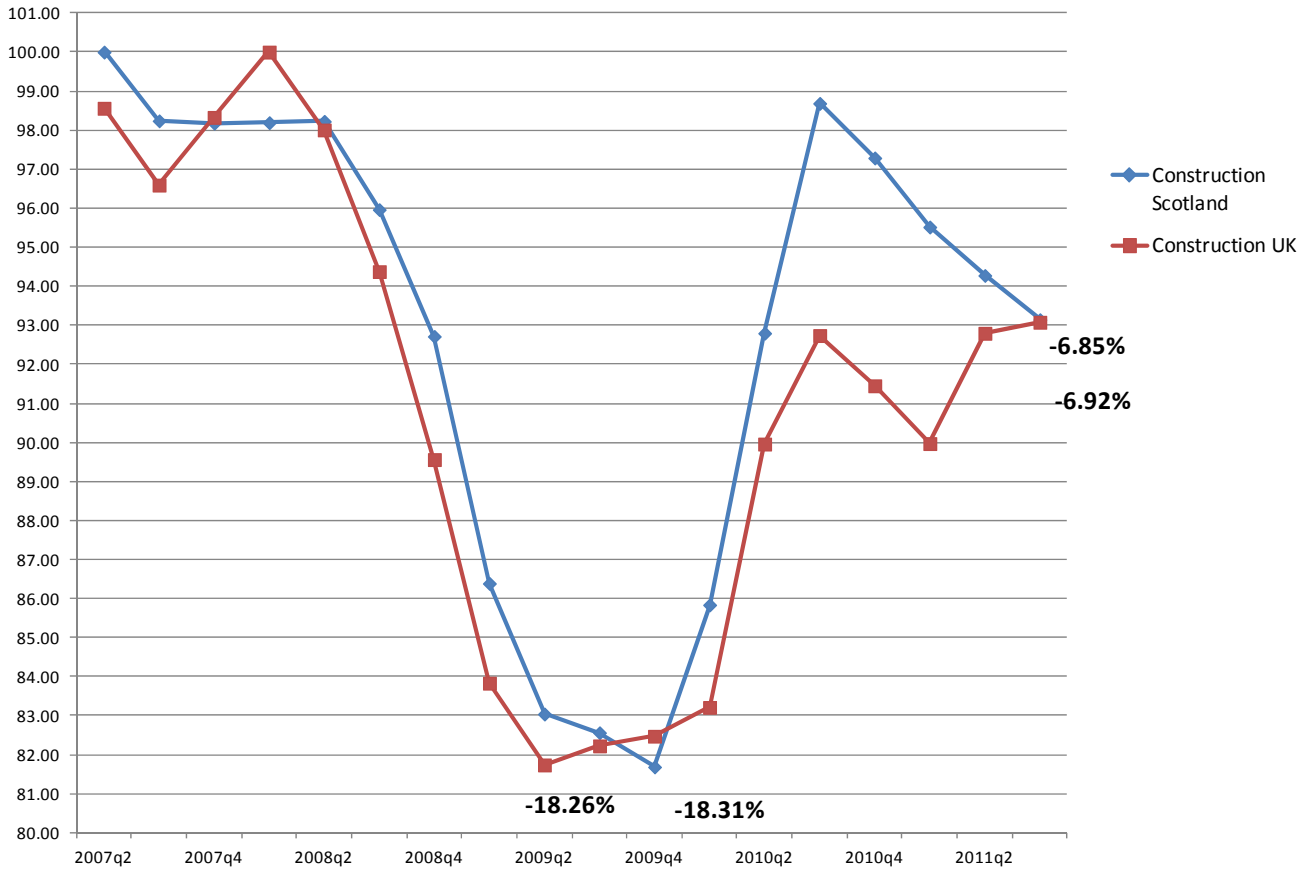
The latest labour market data for the Scottish economy were not encouraging. However, the picture for the UK labour market was a little brighter. Unemployment (on the preferred ILO measure) rose during the final quarter of 2011 by 16,000 to 231,247 or 8.6%, higher than the UK rate of 8.4%. This figure is close to the recession peak of unemployment in May-July 2010 when unemployment reached 236,819. For a detailed consideration of the Scottish labour market see *Overview of the Labour Market* in this Commentary below.

Employment fell by 20,000 to take the Scottish jobs market to a position 3.9% below its pre-recession employment peak - see Figure 11. This is not that much different from the trough of the recession after employment had fallen by -4.8%. The position in the UK on the jobs front is better, however. Net jobs were created during Oct-Dec, by 60,000 even though unemployment rose by 48,000. The inactivity rate also fell quite markedly in the UK whereas in Scotland there was only a slight fall.

All this suggests that with more encouraging data on the output front, the UK labour market might be beginning to turn round although unemployment may rise for a little while yet. This does not disguise the fact that unemployment remains high by historical standards. **Jonathan Portes,** Director of NIESR, demonstrates that the 'unemployment gap' between actual unemployment and the rate of unemployment that is estimated to be associated with non-accelerating inflation is exceptionally high and of long duration by historical standards. The 'unemployment gap' if positive indicates the amount of unemployment due to a deficiency of demand and hence a failure of macro-economic management. With a large element of this gap being made up of 'youth' unemployment - more than 100,000 estimated in Scotland - the risk of hysteresis, with a generation of employees losing, or failing to gain, key employment skills, is high.

In Scotland, the labour market is now clearly weaker than the UK. There is no better indicator of this than a comparison of the amount of employment on offer with the available labour supply. As Figure 12 reveals the amount of jobs on offer compared to the available labour supply is now identical to the trough of the recession.

Figure 8: Construction: Recession and Recovery to 2011q3



Given that the growth of output remains weak it is likely that unemployment will continue to rise in Scotland for some time yet. Moreover, Scotland's position compared to the other regions of the UK, which has also been weakening, may continue to worsen - see Figure 13.

Re-balancing the Scottish economy

The shock to the economy of the Great Recession continues to reverberate. Not only has the recovery been weak, there are fears that a large proportion of supply has been permanently lost, and that there has been a desired permanent shift in the composition of demand away from one set of productive activities to another set. There are activities such as investment banking, containing both tradable and non-tradable elements - see below, which it is arguable have been permanently reduced in the UK following the boom and slump. In general terms, the IMF has found that downturns associated with significant disruption to the financial sector are often characterised by large and persistent output losses[1].

On the demand-side, Ben Broadbent – External Member of the Bank of England Monetary Policy Committee (MPC) - has argued that the large fall in sterling in 2007-08 "...reflects the need to rebalance UK supply – away from non traded goods and services, and towards the production of tradables – in order to match an equivalent shift in the composition of demand"[2]. Broadbent's argument is that first, debt financed spending on housing, in particular, and perhaps other forms of property, has fallen for the foreseeable future. In addition, the loss of tax revenues as a result of the recession has been significant. Broadbent points out that tax revenues in 2009-10 were £109bn lower than expected in early 2007, equal to almost a third of current government spending on public services. The government has started a major and seemingly permanent cutback in government consumption, rightly or wrongly, as a result of the loss of tax revenues and rising debt. The main impact of this lowered spending will be on the demand for non-tradables. While in the short-to-medium term the government sees switching from public to private demand, household to export demand, and consumption to investment demand, there is a sense that, in the longer term, the required sustained switch is one from non-tradables to tradables. Exports, in particular, will have to play a greater role in the growth of both UK and Scottish economies.

To the extent this argument is correct, the future course of the economy i.e. growth and its composition, will depend on how successful and how quickly the economy can adjust away from the non-tradable activities that are less in demand towards tradable activities. And the most important tradable activities are manufacturing and tradable business and financial services.

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Figure 9: Business & Financial Services: Recession and Recovery to 2011q3

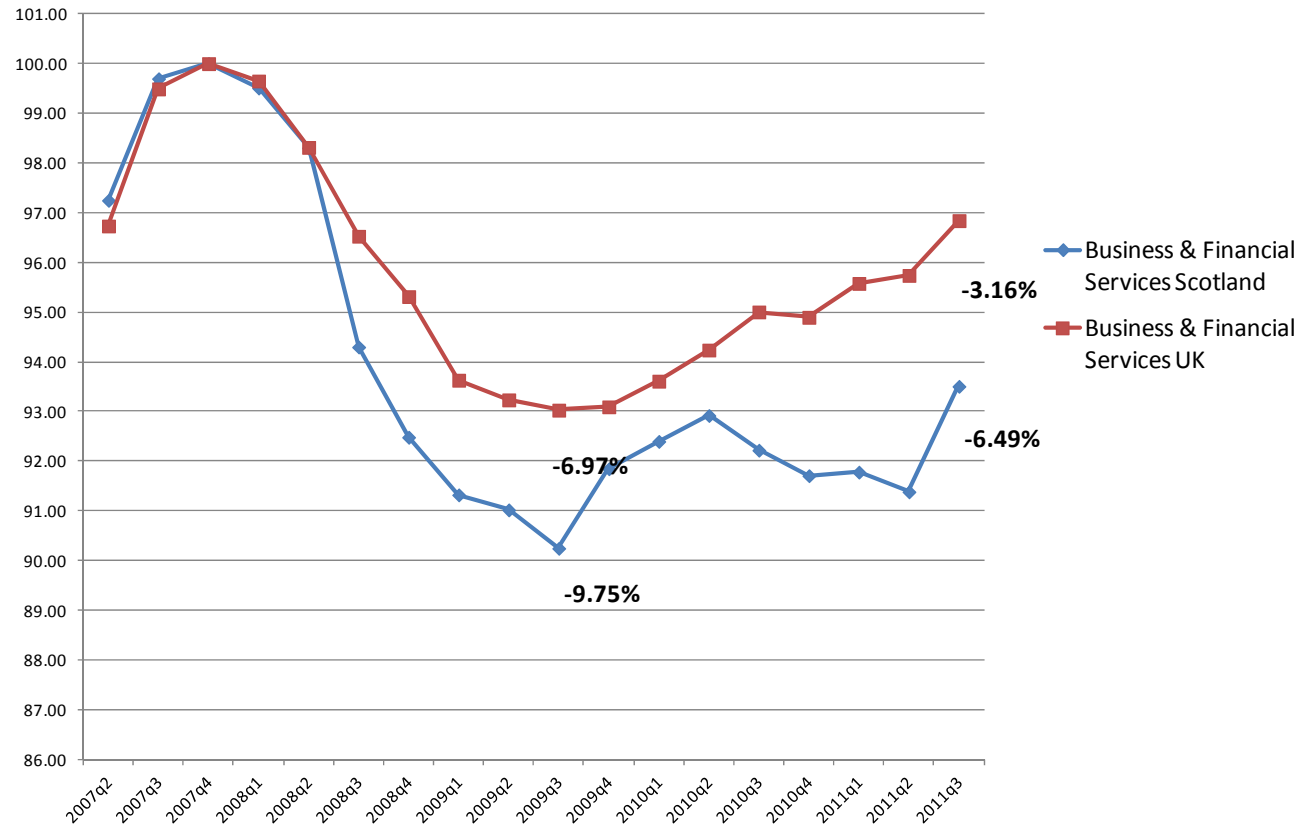


Figure 10: Scottish Manufacturing Export Growth 2003 to 2011 - Percent, four quarter moving average

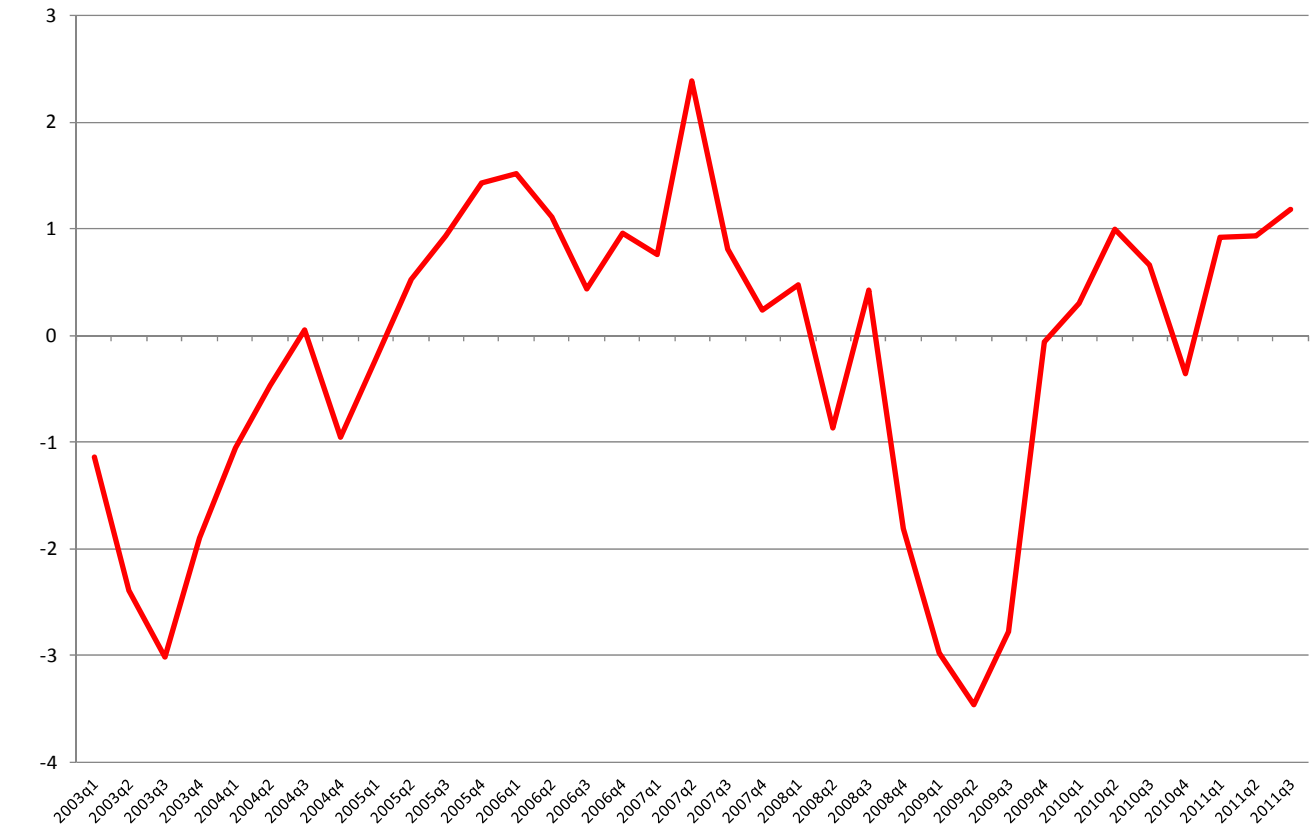


Figure 11: Scottish and UK jobs, 16 and over, compared to pre-recession peak

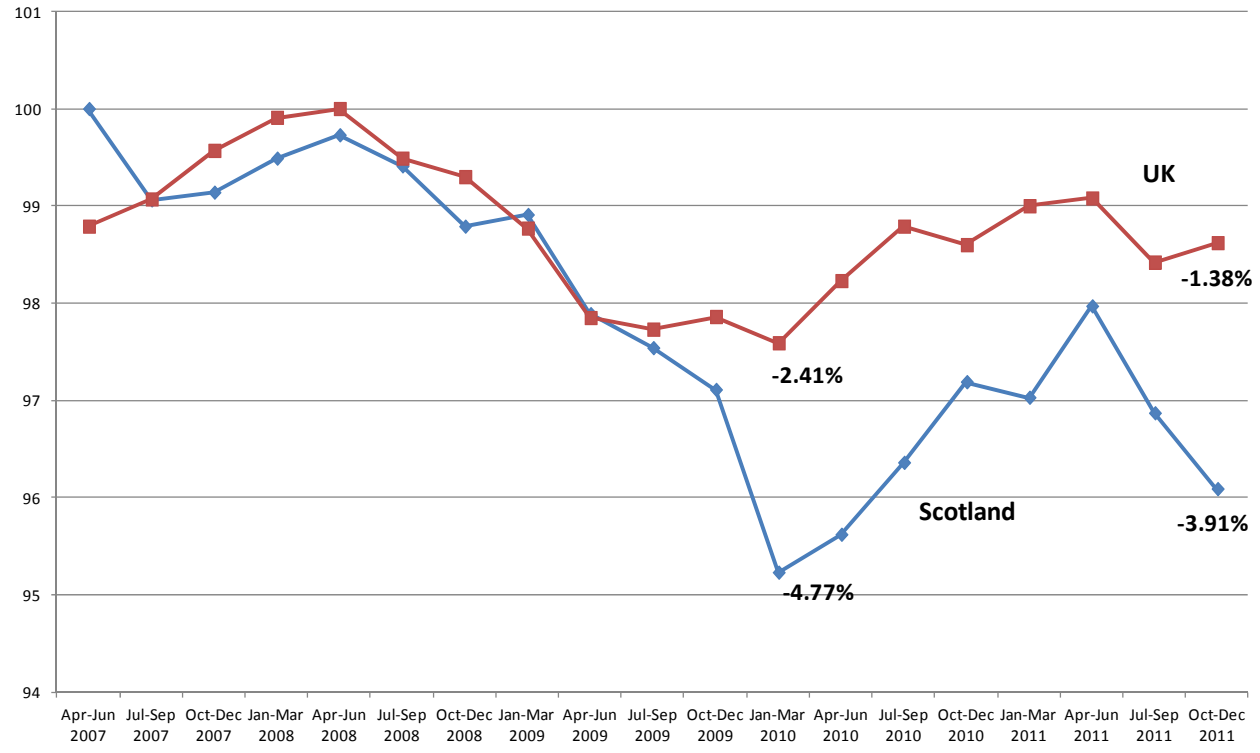
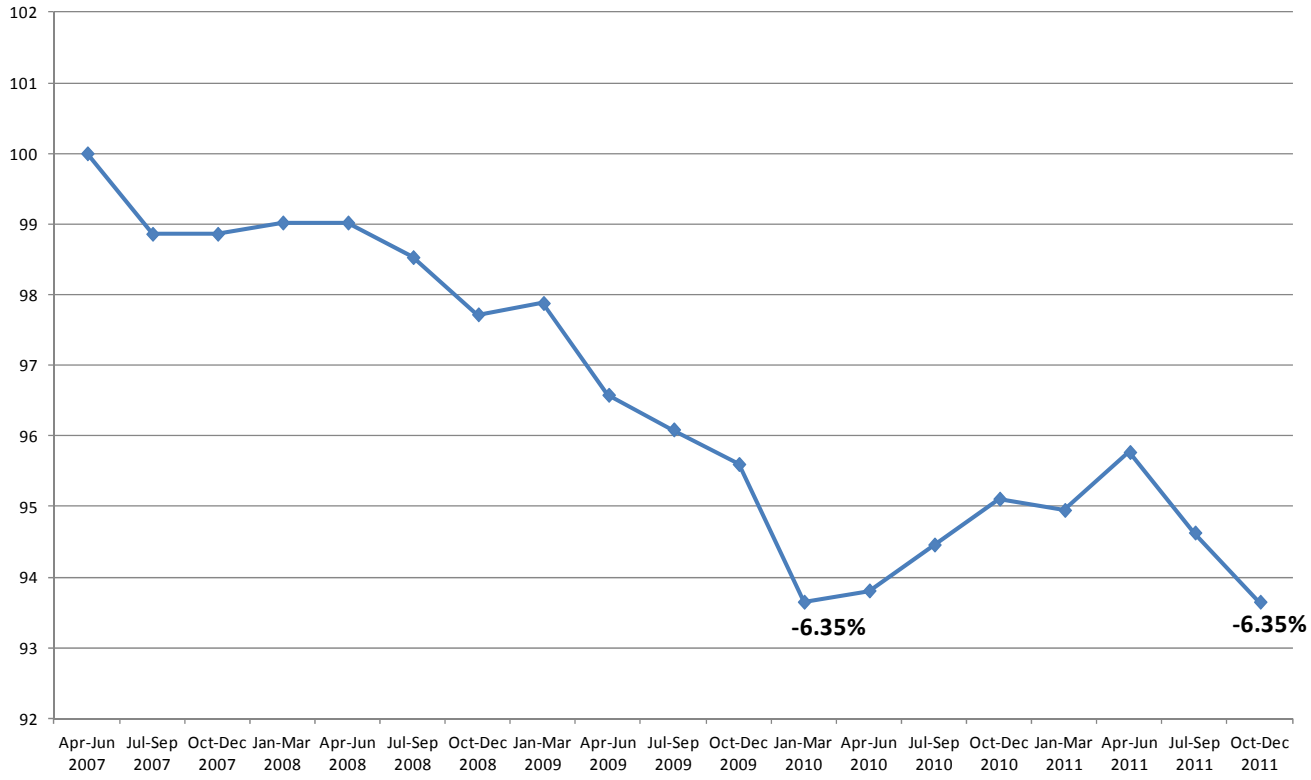


Figure 12: Scottish Employment to Working Population ratio compared to pre-recession peak in April-June 2007 to Oct-Dec 2011



All this begs several questions when it comes to Scotland. First, what evidence is there on changes in the demand and supply for non-tradables and tradables as a consequence of the recession in Scotland, both absolutely and relative to the rest of the UK? Secondly, what are the prospects for the growth of the Scottish tradables sector in the medium to long-term?

Data are limited but we do have the latest ONS Regional activity data that were published in mid December. The Regional Accounts data provide information on sectoral GVA up to 2009 and overall 'regional' GVA to 2010. Figure 14 shows the sectoral GVA shares before - 2007 - and during/after the recession - 2009 - in Scotland.

Figure 14 offers some support for the view that switching between non-tradables and tradables began during the recession. Of the typical non-tradable sectors, construction's share of Scottish GVA dropped from 9.1% to 7.4%, wholesale and retail etc, dropped marginally from 10.1% to 10%, real estate activities fell from 7.5% to 6.5%, and transportation and storage reduced its share from 5% to 4.8%. However, public sector activities that embrace the three sectors, Human health etc, Education, and Public Administration etc., increased their share of GVA slightly between 2007 and 2009 from 21.3% to 22.8%. The rise in public non-tradable activities would appear to be the inevitable initial consequence of a private sector recession. The government maintained its own demand in the recession as it traditionally now does. But once fiscal consolidation finally works through then it is likely that the share of public sector activities will fall.

Turning now to the largely tradable activities, there is some suggestion of rising GVA shares, although by 2009 the increase was small. Manufacturing's share of overall GVA rose from 11.5% to 11.9% and this despite a large drop in real manufacturing GVA as measured by the Scottish government's own GVA index. Also, the share of financial services and insurance in overall GVA rose from 7.1% to 9%. This is in many respects surprising, given the source of the recession in a banking crisis, where one might have expected demand to fall disproportionately in financial services and perhaps even some supply to have been lost. The rise in the share might indicate that the effects of a relative price shift in demand towards tradable elements of financial services outweighed the income effect in reducing demand but I doubt it. What needs to be allowed for is the extent to which the sector was able to maintain and increase its 'market' share by raising prices. It is possible that the lack of competition in the sector, particularly in areas such as business finance, enabled this to happen. It certainly chimes with anecdotal evidence about the behaviour of the banks during and after the recession in terms of charges for new lending and re-financing. Moreover, the rise in the share of financial services following the recession was not simply a Scottish phenomenon and was evident right across the UK as Figure 15 shows.

In contrast, the rise in the share of manufacturing in overall GVA was much more a Scottish phenomenon. Indeed, as Figure 16 shows, the share of manufacturing in UK GVA fell between 2007 and 2009, from 11% to 10.3%.

Only in Scotland and Northern Ireland did the manufacturing share of GVA rise. But in regions such as the North East and the West Midlands, the drop in the manufacturing share was large from 15.3% to 13.2% in the former and 14.6% to 12.8% in the latter.

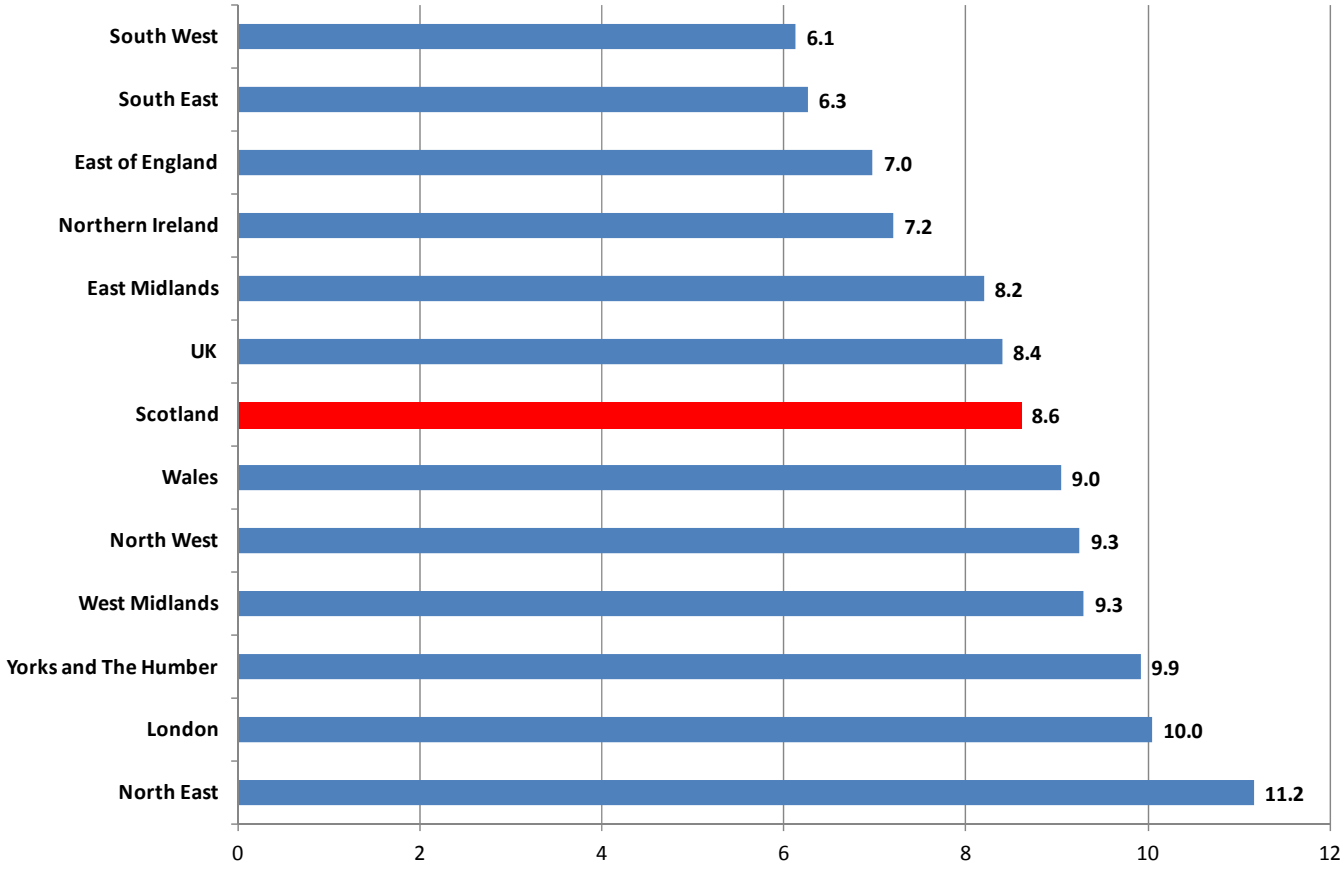
So, we have tried to offer some answers to our first question: what evidence is there on changes in the demand and supply for non-tradables and tradables as a consequence of the recession in Scotland, both absolutely and relative to the rest of the UK? The evidence appears to show that a shift in demand away from non-tradables towards tradables has occurred. However, there is clear evidence of a relative fall in some non-tradable sectors but weaker evidence of a relative rise in sectors considered to be largely tradable. The picture appears also to be confused by the income effect of the recession, which caused demand to fall for all goods and services, although the incidence of the drop in demand varied across sectors. What we can say is that manufacturing, the principal traded sector, held up relatively well in Scotland. This could mean that, in answer to our second question, the Scottish economy may be well placed to take advantage of the expected sustained switch in demand in favour of tradables in the future.

However, the prospects depend on the supply response of the Scottish economy. That is, how easily the economy allows existing resources to switch from non-tradable activities in reduced demand, along with the allocation of new resources, to manufacturing. We saw above that while manufacturing exports from Scotland are recovering the recovery to date is fitful.

We have undertaken a detailed analysis of Scottish exports over the past 10 years using data from the recently published Global Connections Survey, the Index of Manufacturing Exports, and the Scottish Input-Output tables. Some of the results from this exercise are presented in Box 1 of the *Forecasts of the Scottish economy* section in this Commentary below. What this analysis suggests, in broad terms, is that the rest of the UK (RUK) became more important as an export destination and service sector exports rose as a proportion of total exports and so increased in importance relative to manufacturing. However, these findings need to be hedged with one or two qualifications.

First, the growth in importance of RUK exports as a proportion of total exports reflected the strong growth in service and financial service sector exports up to 2007 just prior to the start of the recession. Between 2008 and 2010, the annual rate of growth of total exports declined considerably from the period 2002 to 2007. This was very

Figure 13: Unemployment rate % (ILO measure) UK Regions Oct-Dec 2011



much the result of a drop in exports to RUK, which fell from 9.9% per annum to 0.6% per annum, still managing some positive growth[3]. Exports to the rest of the world (ROW), in contrast, went from -0.5% annual growth in 2002-07 to -0.6% in 2008-10, i.e. they were falling over the whole period.

Secondly, we cannot get a proper appreciation of the underlying performance of manufacturing exports and contribution to exports as a whole, unless we remove the electronics sector. Because of the world-wide recession in ICT in 2000 and thereafter, electronics production in Scotland halved and the sector's contribution to exports fell considerably. With the removal of electronics, the annual growth rate of manufacturing exports to RUK pre-recession and then during recession falls from 4.0% per annum to 1.4%. Over the same period service sector exports to RUK fell from 13.4% per annum to -0.9%. So exports of manufactures (ex electronics), and manufacturing overall, to RUK held up better than service exports. Moreover, manufacturing (ex electronics) exports to ROW were growing quite strongly in the pre-recession period by 4.4% per annum but less than service exports to ROW, which grew strongly by 8.9% per annum. In the recession manufacturing exports (ex electronics) fell to -1.4% per annum while service exports to ROW although contracting considerably managed to record some positive growth of 1.4% per annum.

So, we can conclude by making the following points:

- It appears likely that the future growth of the Scottish economy will depend more on tradables than non-tradables than it has done in the past. Policy needs to recognise this. Although, recent evidence suggests that the rebalancing process is already underway.
- The growing importance of tradable service exports suggests that export promotion policies should not simply assume that manufacturing is the only source of strong export growth.
- Equally, the weak performance of Scottish exports to the ROW and the weak performance of manufacturing exports within that total, should not produce a counsel of despair.
- The weak Scottish export performance to ROW over the past 8 to 10 years is mainly down to the significant loss of electronics production at the beginning of the period and the effects of recession at the end of the period.
- Policy needs to recognise the importance of the RUK market as a legitimate target for 'export' promotion policy.

Figure 14: Sectoral Shares (%) of Scottish GVA: 2007 and 2009

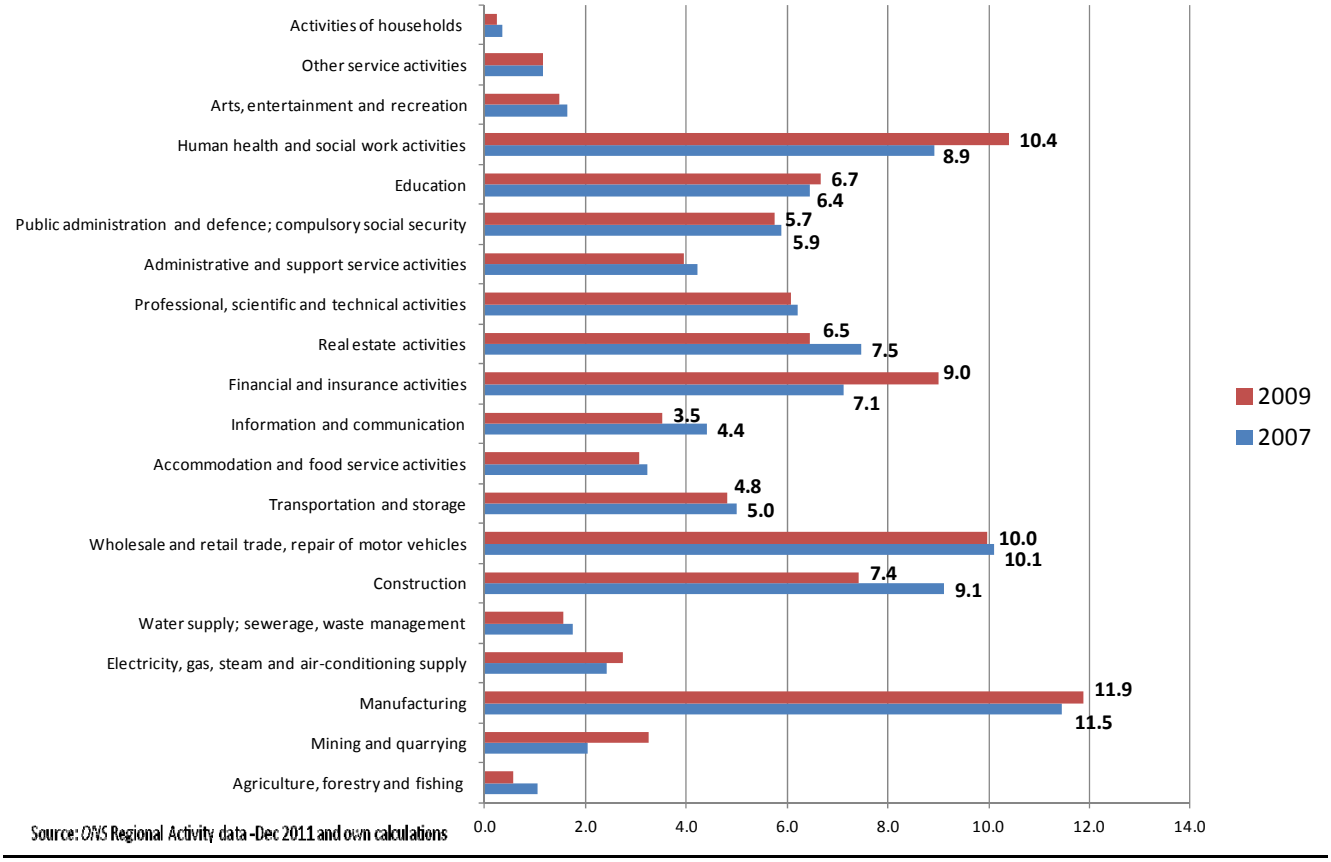


Figure 15: Financial Sector GVA Shares in UK Regions before and in recession, 2007 and 2009

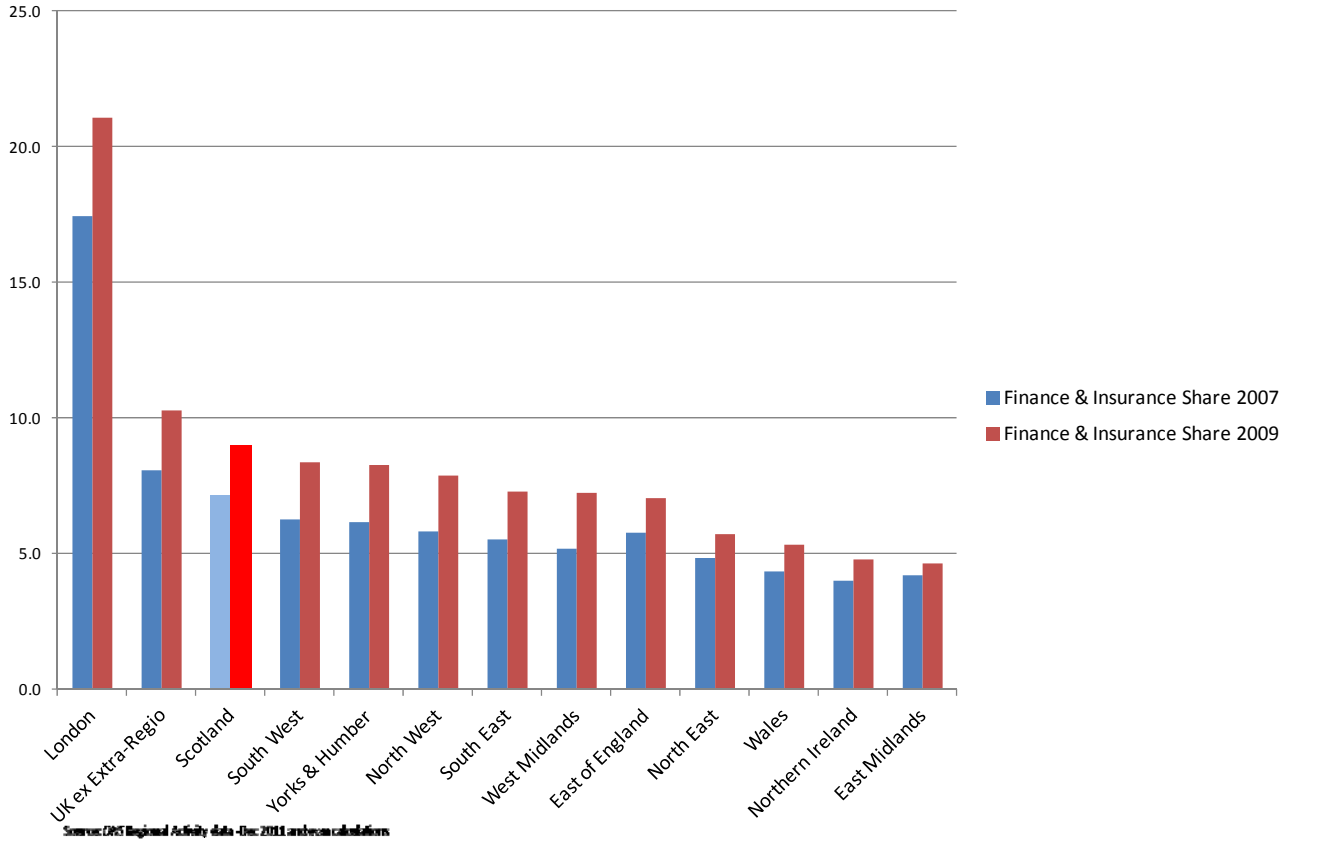
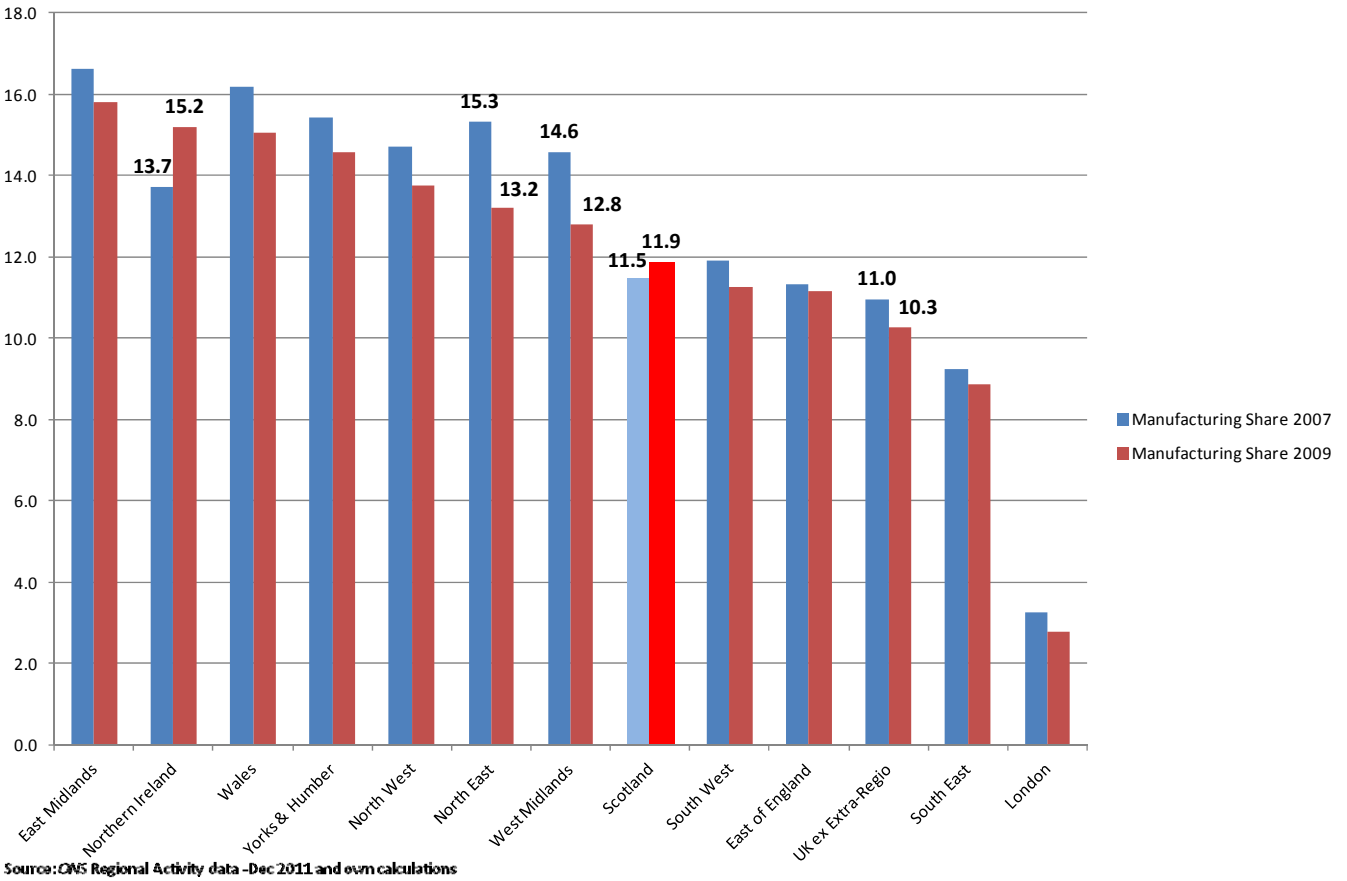


Figure 16: Manufacturing GVA Shares UK Regions 2007 and 2009



- However, the continuing weakness of UK household demand might also suggest that the recent shift in the balance of exports in favour of the rest of the UK could hamper the necessary rebalancing of Scottish industry in favour of the production of tradables and exports.

Forecasts

Background

Real GDP in the UK economy contracted by 0.2% in the final three months of last year. A key question is whether this fall in GDP is a portent of worse to come, or will this weakening in an already weak recovery be temporary? The question cannot be answered with much certainty. As we noted above GDP is around 4% below its pre-recession peak. It is the production sector and construction that is displaying the greatest weakness, with manufacturing (-0.9% in the quarter) contributing most to the decline, while the service sector slowly recovers. But mining and quarrying also contracted by -1.1% in the quarter and the ONS cites the drop in North Sea Oil production as a key factor. Indeed, the sustained weakness of oil production in the UK is shown to be a contributory factor in the weakening UK trade position. The near term prospects for production output, which contributes 15% to overall UK GDP do not look promising. Most of the broad product groupings are either exhibiting a downward trend or flat growth. Moreover, both consumer durable and non-durables are contributing little to growth, with no sign of an upturn. This clearly reflects the state of UK consumer demand as households continue to pay down debt and deal with declining real incomes.

The situation in services in the UK is a little more reassuring. The performance of business services & finance is encouraging and should support future growth. But with fiscal consolidation beginning to bite the still positive contribution to growth from Government & other services might be expected to diminish.

We noted above that the recovery was meant to be based on a switch from domestic to external sales, from consumption to investment, and from public to private activity. There is little evidence of this occurring much in the latest statistics. What the outturn data suggest is that we might expect to see more negative GDP growth in the UK in the first half of this year, or at best stagnation. But it is not all gloom. Net jobs are being created in the UK labour market even though unemployment and particularly youth unemployment is unforgivably high. The rate of inflation is falling as last year's VAT increase falls out of the statistic and the rise in import prices especially commodities and energy costs have moderated. Although the recent rise again in the price of oil to above $120 per barrel, driven by

events in Iran, leads one to be cautious about the prospect for a rapid fall in inflation. Moreover, while the mainstream view is that a fall in the inflation rate back to target will give a relative boost to real incomes and so encourage a rise in household demand, the view might be misplaced. If the pressing need of households is to pay down debt and present real incomes mean that there actual saving is below the precautionary saving desired to pay down debt. Then a rise in real income could lead to higher savings with little or no impact on household demand. Nevertheless, if this is any comfort, the latest Markit Household Finance Index shows household finances still worsening but deteriorating at their slowest rate since December 2010. The survey also suggests that household debt may have stabilised, which I assume means has stopped rising.

Other UK survey evidence is a little more encouraging. The Markit/CIPS UK Services PMI showed that UK service sector growth improved in January to the strongest level since March last year. New orders were up and business orders rose considerably leading Markit's Chief Economist Chris Williamson to comment that "... (t)he surprisingly strong upturn in the service sector follows a similar improvement in manufacturing and ongoing growth in construction, which all points to a resounding revival of UK economic growth in January. The situation is certainly a lot brighter than seen in the final quarter of last year, when the economy contracted 0.2%, and a slide back into recession is now looking increasingly unlikely."

However, we would still argue that the scale and speed of the UK Coalition's fiscal austerity programme is a mistake, and that there is sufficient 'fiscal capacity' to slow the process down. We are not alone in this view. For example, the Oxford macro-economist Simon Wren Lewis argues that "the speed of fiscal tightening .... is too rapid. In the UK in 2010, for example, there was a clear risk that private sector demand would not pick up in 2011. The risk coming from the Eurozone was also apparent. In these circumstances, the prudent policy option was not to scale back public spending too rapidly, because there was no insurance policy in place if these risks materialised. They did materialise, and UK growth stalled. The Eurozone is making exactly the same mistake, in perhaps a bigger way." [4] Wren Lewis then comments on the risks of rising debt and loss of market confidence "(O)ne simple point is worth making again and again. If the recession reflects additional net saving by the private sector, they want to hold more assets. Furthermore, given the character of the recession, they want to hold relatively safe assets. There is a literature on the current shortage of safe assets. Budget deficits provide those assets, but still interest rates on debt are falling outside the Eurozone because there are not enough of them. This too points to budget deficits being cut too quickly."[5]

The so-called 'elephant in the room' remains the situation in the Eurozone (EZ). On Tuesday 21st February, the EZ finance ministers secured agreement on a much-postponed €130bn second bail-out for Greece. This was secured after private holders of Greek bonds were cajoled into taking a greater loss of 53.5 per cent on the face value of their bond holdings compared to the 50 per cent agreed in October. In net present value terms the size of the 'haircut' amounts to a loss of 70%. The revised arrangements followed a report prepared for the EZ finance ministers which suggested that the current proposal would on a 'downside scenario' be likely to result in a Greek debt to GDP ratio 160 per cent by 2020 instead of the desired 120 per cent. The figure of 120 per cent is considered to be the maximum level that would make the Greek public finances sustainable. All the i's have not been dotted nor the t's crossed on the deal, so it could yet collapse.

Moreover, one reason why the report considered that the previous proposal would not get the debt ratio to 120 per cent was the effect of austerity in lowering Greek GDP. This problem still remains and many economists believe that there is little likelihood of Greece getting on to a sustainable public finance track under the present strict austerity conditions required by the EZ. A disorderly default continues to have a high probability. In addition, it is very unlikely that austerity and the use of demand reduction to force an internal devaluation to improve Greek competitiveness will work at all. So, even if financing is delivered in the short-to medium term, the problem will return because of the lack of adjustment in the competitiveness of the Greek economy. Another reason why a Greek exit from the EZ has a high probability. Despite these caveats, the markets have given the EZ the benefit of the doubt and yields on the main peripheral country bonds have fallen over the last few weeks, helped considerably by the ECB's significant injection of liquidity into the banking system. The ECB has *de facto* been acting as a lender of last resort, with the banks using the increased liquidity to fund some of the debt of the peripheral sovereigns. The problems posed by the EZ member country balance of payments and debt crisis have eased, for the moment.

Yet growth continues to be weak in the EZ and this amongst other factors is affecting growth in the Scottish economy. We noted in the previous Commentary that more than half of Scotland's exports outside the UK are to EU economies mostly within the EZ. In the present Commentary below in the section on the *Forecasts of the Scottish Economy* a weak growth forecast for the EZ is noted as well as the downside risk: a central forecast of 0% in 2012 and 1.4% in 2013, with the downside scenario a forecast of -2.1% in 2012 and -1.2% in 2013. It is noted that this is a remarkable range (2.6 percentage points in absolute terms) between the alternative scenarios at such a forecast horizon, and clearly highlights the risk to growth in the EZ if there is a major deterioration in the financial crisis.

Scotland cannot help being touched by weak household spending in the rest of the UK as well as the deteriorating conditions in the EZ. Currently household spending in Scotland remains very weak, with wages increasing at below previous rates and a continued high rate of household

savings. Prospects for investment growth in Scotland through the first half of 2012 also appear weak. For example the data on the growth of inventories growth in the UK suggests a lower rate of stock building in key sectors. Government resource (current) spending is forecast to reduce in real terms over the next three years at an increasing rate as departmental cuts outlined in the CSR from Autumn 2010 are implemented. The IFS in January 2012 outlined that some 88% of planned DEL reductions have yet to be implemented. This will continue to exert a downward pressure on domestic demand. Moreover, the data appear to suggest that government spending has fallen faster in real terms in Scotland than in the UK as a whole.

The prospects for Scottish exports remain very uncertain. Growth prospects in the rest of the UK – Scotland's largest export market – remain low. Scottish export prospects to the rest of the UK are strongly correlated with UK economic growth, so weak growth is likely to be bad for Scottish exports. Yet as the latest data from the CPB Netherlands Bureau for Economic Policy Analysis show the growth of world trade may be picking up again after slowing for much of last year. But given that 67% of Scottish exports go to the rest of the UK it what happens to the growth of income there that really matters.

Some light on the most recent performance of the Scottish

Table 1: Forecast Scottish GVA Growth, 2011-2014

GVA Growth (% per annum)	**2011**	**2012**	**2013**	**2014**
Central forecast	**0.7**	**0.4**	**1.7**	**2.6**
November forecast	*0.4*	*0.9*	*1.6*	*na*
UK median independent new (February)	0.9	0.5	1.8	
Mean Absolute Error % points	+/- 0.153	+/- 0.548	+/- 1.216	

economy can be shed from survey data - see *Review of Business Surveys* section below. Surveys of Scottish business up to January continued to highlight concerns about the implications of the sovereign debt crisis in the EZ. Business confidence was also dampened by continuing fears of recession in the UK and internationally, and fears about pressures on household spending. However, the surveys since January particularly the UK wide surveys suggest that activity, may be beginning to pick up. We noted above the findings of the UK PMI for January which reported an increase in the service sector, at the fastest rate since March 2011. What remains unclear is whether this represents only a temporary improvement, as was the case last year in the first quarter which faded later in the year as the headwinds facing the UK economy became clearer, or represents the first signs of a more permanent upward trend.

GVA Forecasts

For our latest GVA forecasts we continue the presentational procedure adopted in the previous Commentary. We present only a central forecast but use estimated forecast errors to establish the likely range that the true first estimate of the growth of Scottish GVA will lie between. In this forecast, we extend the forecast horizon to include 2014

Table 1 presents our forecasts for Scottish GVA - GDP at basic prices - for 2011 to 2014. The forecasts are presented in more detail in the *Forecasts of the Scottish Economy* section of this Commentary below.

Table 1 shows that we have revised our forecast for all years. For 2011, we have raised our forecast from 0.4% to 0.7%. The increase in output measured for the third quarter of 2011 was stronger than we expected (a 0.5% increase), and broadly tracked the UK growth in that quarter. This upwards revision has brought our forecast in line with our earlier forecast from June 2011, where we forecast 0.8% growth during 2011. In March 2011 we had forecast annual growth of 1.0% in 2011. Our forecast of 0.4% for 2012 is not inconsistent with one, or possibly two, quarters of negative through 2012. Indeed, we note that the Bank of England's Governor, Mervyn King, had remarked on the possibility of a "zigzagging" phase for growth over the coming year. Continuing weakness in household consumption and investment are the key reasons for the downward revision. In November 2011, we forecast growth in 2013 of 1.6%, so our latest forecast is revised up slightly. This is the first instance that we have forecast growth in 2014. By then a significant recovery is expected to be present, with growth above trend.

Our GVA forecasts are compared with the median of latest independent forecasts for the UK in 2011, 2012 and 2013 that are published by the UK Treasury. These show that we expect Scottish growth to continue to be weaker than the UK but growth in the two jurisdictions is now expected to be much closer together, in line with the evidence from the recovery to date.

Table 2: Forecast Scottish Net Jobs Growth in Three Scenarios, 2011-2014

		2011	2012	2013	2014
Upper		-37,377	-4,816	47,244	63,745
	November forecast	*11,150*	*18,850*	*41,100*	
Central		**-40,401**	**-15,988**	**23,213**	**38,023**
	November forecast	*4,900*	*8,750*	*16,200*	
Lower		-43,437	-27,695	-1,853	12,126
	November forecast	*-1,550*	*-1,350*	*-9,250*	

Table 3: ILO unemployment rate and claimant count rate measures of unemployment under each of the three forecast scenarios 2011-2014

	2011	2012	2013	2014
ILO unemployment				
Rate (ILO un/TEA 16+)	**8.6%**	**9.8%**	**9.3%**	**8.8%**
Numbers	**231,200**	**265,250**	**253,950**	**234,300**
Claimant count				
Rate (CC/CC+total job)	5.3%	6.1%	6.5%	6.1%
Numbers	141,500	164,450	177,750	166,350

So, we are now forecasting growth of 0.7% in 2011, 0.4% in 2012, 1.7% in 2013, and 2.6% in 2014. Given our previous forecast errors the lower and upper bounds for growth in 2011 are expected to be 0.5% and 0.9%. for 2012, -0.1% and 0.9%, and for 2013, 0.5% and 2.9%.

Production and manufacturing output are projected to continue to be the main sectoral drivers of growth, with Production forecast to grow by 1% this year compared to service sector and construction growth of 0.3% which are largely flat-lining. In 2013, production continues to be the main sectoral driver of growth with growth of 4%. Stronger growth is projected for services and construction of 1.1% apiece but the two sectors will still be recovering slowly. It is not until 2014 that we see much pick-up in growth, a year later than previously forecast. GDP is forecast to rise by 2.6%, while production growth rises appreciably to 6%, service sector growth moves up to 1.9% and the growth of construction GVA reaches 1.7%.

One significant implication of these GVA forecasts is that they suggest that overall Scottish GDP will not return to its pre-recession peak - the level of GDP the economy was at just before it went into recession - until the third quarter of 2014, just in time for the Commonwealth Games in Glasgow (23rd July to 3rd August 2014). That is, six years after the recession began.

Employment Forecasts

Table 2 presents our forecasts for net employee jobs for the 4 years 2011 to 2014 in terms of a central and upper and lower forecasts.

Table 2 indicates that our year-end employee jobs forecast have been reduced further from the forecasts presented in the November Commentary. The lower forecasts reflect the weaker than expected outcomes in the labour market in the final quarter of last year, data revisions and the reduced forecast for GVA in 2012. On the central forecast, net jobs grow by -1.8% in 2011, -0.7% in 2012, 1.0% in 2013 and by 1.7% in 2014. The number of employee jobs in Scotland is forecast to decline during 2012 by just less than 16,000 jobs. Within the sectors, however, we are forecasting a reduction in jobs in the service sectors of over sixteen thousand jobs. Public sector reductions in employee jobs are forecast to be around 7 thousand over the year. We are also forecasting reductions in jobs in Retail and Wholesale but increases in employment in the Business Services sector. Through 2013 and 2014 we forecast increases in employee jobs in our central forecast, with annual increases of over 23 thousand and 38 thousand respectively. There are job increases across all the main sectors. However, as in 2012 we forecast a “rebalancing” of employment within the services sectors towards non-public activities as fiscal consolidation continues. Construction employment is forecast to increase in 2013 and 2014 as spending on

(private) investment projects returns with renewed confidence in the recovery.

Unemployment Forecasts

The key unemployment forecasts are summarised in Table 3 .

The ILO rate is our preferred measure since it identifies those workers who are out of a job and are looking for work, whereas the claimant count simply records the unemployed who are in receipt of unemployment benefit. It appears from the latest data that employment growth has been weaker in Scotland than other regions, reducing the pull of labour into employment. Our forecast for unemployment on the ILO measure at the end of 2012 is now 265,250, up 34 thousand from the level seen at the end of 2011. As with our last forecast, we are expecting the unemployment position to improve through 2013, and are now forecasting unemployment at the end of that year of 253,950. We are forecasting that the rate of unemployment at the end of 2012 will be 9.8%, up significantly from our earlier forecasts. However, as previous quarters have demonstrated there is considerable uncertainty around the unemployment forecast due to the extent to which output change map into job change, changes in working population and independent variations in activity rates. In addition, we note the uncertainty around some of the employment estimates. We are concerned that some of the reported employee jobs series e.g. the series for Health, social work and care sector, may overestimating the growth through 2011. If these are subject to later downward revision then employment levels could be much worse than our current statistics suggest.

Brian Ashcroft
24 February 2012

Endnotes

[1]See IMF, 2009, "What's the Damage? Medium-term Output Dynamics After Banking Crises" World Economic Outlook, October.

[2] "Rebalancing and the Real Exchange Rate" – speech by Ben Broadbent , 26 September 2011

[3]This doesn't sit too well with the Regional Activity

[4]mainly macro at http://mainlymacro.blogspot.com/2012/02/budget-deficits-changes-levels-and.html

[5]Wren Lewis op cit

The Scottish economy

Forecasts of the Scottish economy

Summary

The Scottish economy is likely to have seen negative growth in the final quarter of 2011. Further, the Scottish labour market has displayed weakness over the last few months as unemployment has increased and employment fallen. The outlook for domestic spending looks bleak in the short term due to slow wage growth and is further weakened over the medium term by reductions to household benefits, despite reductions in inflation easing some of the squeeze on real incomes. Prime export markets for Scottish goods and services appear to have returned to recession, with Euro Area forecasts cut radically since our last forecast. Without a switch of exports to fast-growing markets, or a (increasingly unlikely) quick return of stability to the Euro Area, the prospect for an export-led recovery appear limited in the near term. Job numbers are forecast to decline through 2012, recovering slowly through 2013 and 2014, with unemployment forecast to be 9.8% at the end of 2012 and decline from there to the end of the forecast window.

Monetary policy

Currently, inflation appears to be heading in a rapidly downwards direction, with the CPI measure having fallen in each of the last four months. Prices are still increasing on the year, but at a lower rate – largely in line with expectations, as temporary shocks (including the VAT increase back to 17.5%, one-off increases in energy costs and higher import prices) work their way through the inflation measure. At the time of writing inflation had seen a large one month move from 4.2% in December to 3.6% in January 2012. The RPI rate had fallen by further in this same month, down from 4.8% to 3.9%.

In the face of falling inflation, the Bank of England's latest Inflation Report (February 2012) notes that interest rates are not expected to rise by 25 basis points until the third quarter of 2014: a point almost two quarters beyond what was expected in the last Inflation Report. This reflects an increasing concern within the Monetary Policy Committee about the downside risks to inflation over the medium term as growth appears weaker. The Bank's central projections for inflation are (after continued falls through the first half of 2012) generally below its target of 2% into 2014. At its February meeting, the Committee discussed raising its programme of asset purchases ("Quantitative Easing") by £50 billion or £75 billion. From the minutes of that meeting we see that seven of the MPC voted in favour of a £50billion increase, up to £325 billion, with the other two members favouring a larger increase. There is increased speculation that this increase in asset purchases may not be the final movement of quantitative easing that the Bank undertakes.

Fiscal policy

The headline from the Scottish Budget introduced earlier this year, and relating to 2012-13 was that most budgets continue to decline in real terms out to 2014-5, with the exception of the NHS budget. Some resource DEL spending has been transferred to annual capital DEL spending, with an additional £382 million between 2012 and 2015 above that level of capital spending previously announced. Roads projects appear to see the largest share of this additional capital spending, but there are also increases in the planned expenditure on stated areas such as rural broadband, NHS capital maintenance and affordable houses. More details of the announced Scottish Budget plans for this coming financial year were addressed in the November's Commentary.

The UK government fiscal consolidation continues, with the IFS estimating that 88% of the department DEL spending reductions have yet to take place. The prospects for government spending, either from Edinburgh or London, to provide a boost to economic activity continues to be limited. Some recent figures for the UK, but not for Scotland, continue to show government spending contributing to GDP growth. This appears to either be severance payments being counted as government spending – and so distorting the "true" path of government spending, or a technical classification issue requiring resolution.

Output

The latest GVA figures for Scotland were published on the 18th of January and relate to Q3 2011. The headline figures show that through 2011 the Scottish economy has increasingly tracked developments in the UK economy as a whole. Q3 saw an increase of growth of 0.5%, identical to that seen in the UK as a whole. Over the year (i.e. a rolling four quarters), growth in Scotland was 0.9%, while the UK saw growth of 1.3%. Scottish GVA remains 3.3% below its peak from the second quarter of 2008, while – at the end of Q3 2011 – the UK was 3.6% below its pre-recession peak from the first quarter of 2008. It is therefore 13 quarters since the peak of output in Scotland.

Looking at the sectoral performance there were however, quite sizeable differences between Scotland and the UK. Over the last year, the Scottish production, construction and agriculture sectors all outperformed the sectors at the UK level. While on the surface this suggests a stronger performance in Scotland, the shifts in the third quarter for these broad sectoral groupings were all weaker in Scotland than the UK. Over the year, the service sector in Scotland grew 0.3%, while at the UK level this sector grew 1.2%. Over the last quarter the Scottish service sector outperformed the UK comparison. This was significantly affected by the growth of the business services and finance sector, which saw growth of over 2%. The construction sector, which had previously shown strong growth on a quarterly basis, shrank by 1.2% in Scotland compared to 0.3% growth in the UK. This confirmed four consecutive quarters of negative growth for the construction sector in Scotland.

The largest contribution to Scottish growth in the third quarter was the business services and finance sector. Construction and production sectors (constituting around 8% and 17% of Scottish GDP respectively) both made negative contributions in this quarter.

The last quarter saw two changes in the methodology used to estimate the Scottish GDP series. The first of these introduced a new price deflator series, replacing Retail Price Index with a Consumer Price Index measure, making Scottish series more comparable to international methods. The second change was a substantial revision to the series on banks and building societies within the financial services sector (comprising around 7% of Scottish GDP). This change has been made retrospectively, with the consequence that developments in this important sub-sector of the Scottish economy now appears to have seen quite a different pattern of growth than previous estimated. The decline in this sector since the start of 2008 has been significantly lessened. Despite sizeable impacts on the financial services sector, the consequences of this change for aggregate Scottish GVA appear to be minimal.

Survey evidence on production during the final quarter of 2011 indicated that this saw a troubled trading period across many sectors, both in Scotland and the UK. Growth in output through January 2012 appears to have moved positively from the levels seen in December, according to the Regional PMI survey. January's PMI survey suggests that while growth across the UK has rebounded strongly at the start of 2012, Scotland has seen a far smaller increase in output than the UK as a whole. Only Wales, Northern Ireland and the South West of England have a lower index for January's figures.

At the UK level, January's preliminary estimate of Q4 2011 GDP was for a decline of -0.2% on the previous quarter. This appears to have been broadly in line with expectations, with a quarter of negative growth expected given weak demand signals in the final quarter. Production sectors at the UK level saw a decline of 1.2% overall, while there was also a contraction in the construction sector (-0.5%) . The aggregate measure of "services" grew by 0% in Q4. The strongest growth at the sectoral level within services was from the government and other public services sector, which grew by 0.4%, and by an estimated 2.5% during 2011. One possible suggestion as to how this can occur during a period of fiscal austerity is that these figures reflect redundancy payments or, indeed, are overstating the contribution of government spending to growth and will be revised down in future quarters – with the impact of revising down overall growth (Kirby, 2011).

Looking forward, January's minutes of the MPC suggest a forecast held by the group for flat growth in Q4 2011 and Q1 2012. This would therefore suggest that small positive

Figure A: Real household consumption, Scotland and UK 1998Q1 to 2011Q3, 2008=100

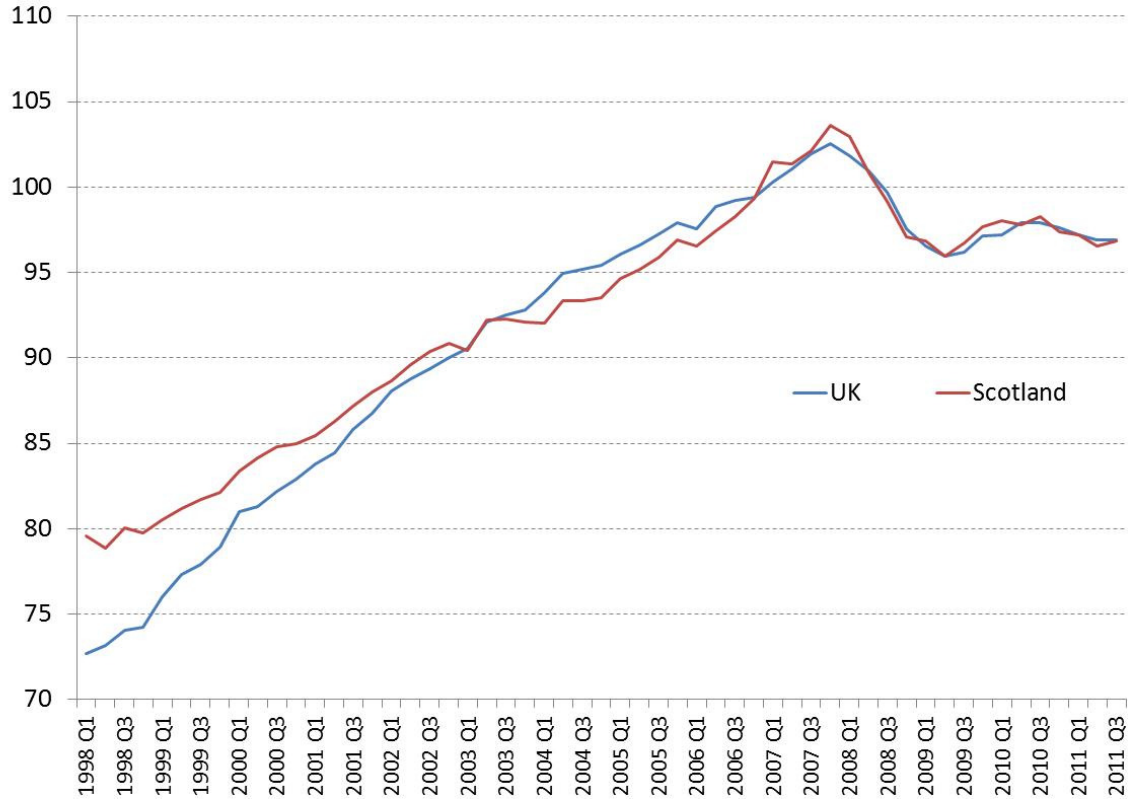


Figure B: Household savings ratio, Scotland and UK, 1998Q1 to 2011Q3

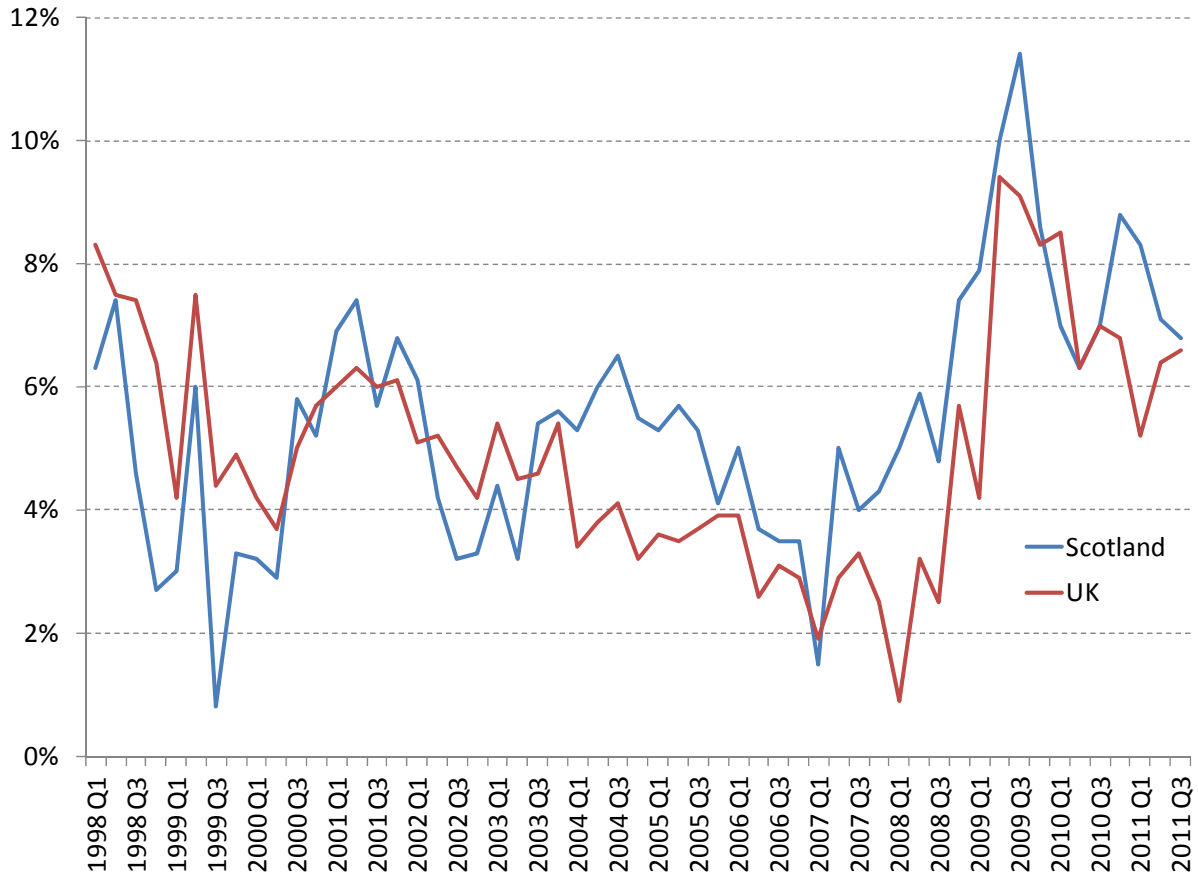
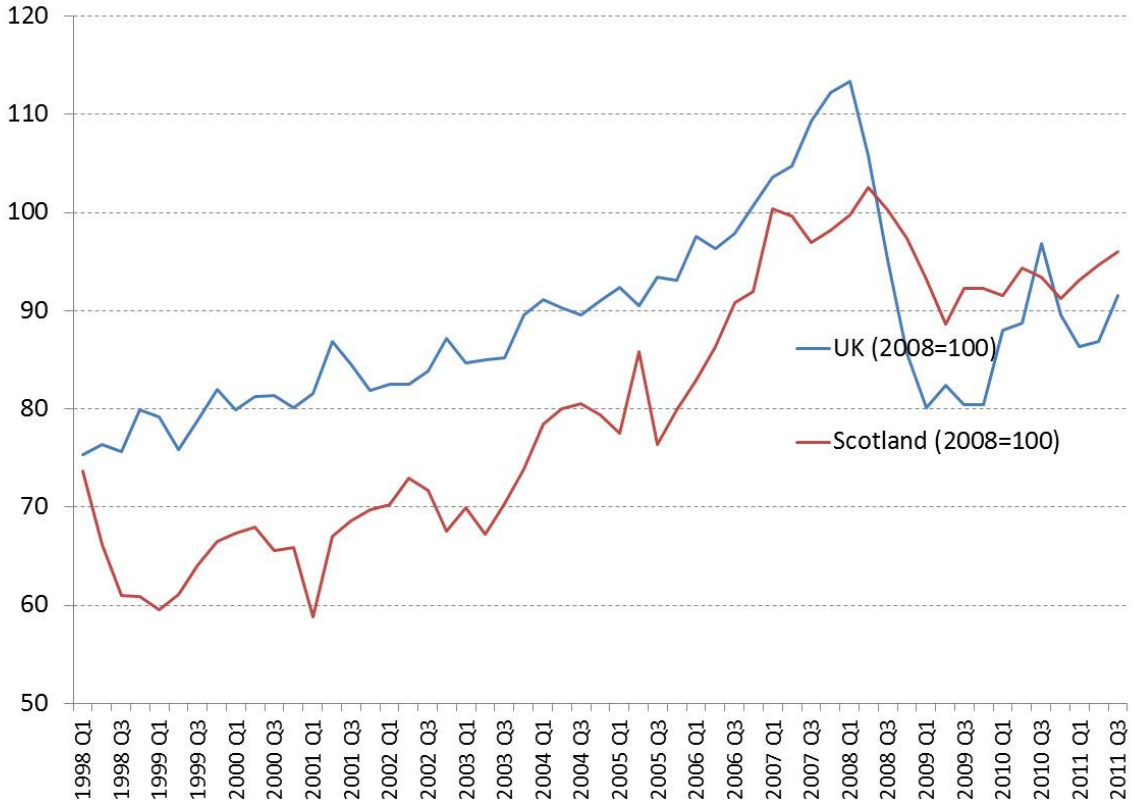


Figure C: Real gross fixed capital formation expenditure, Scotland and UK, 1998Q1 to 2011Q3, 2008=100



growth is anticipated in Q1 2012. Developments through 2012 continue to be shadowed by the prospect of "dislocation" within the core and periphery economies of the Eurozone. Growth forecasts for the UK are discussed alongside the central forecast for Scottish growth.

Household

As noted in the Overview of the Labour Market section of this Commentary, wage growth has fallen since 2007, and in the year to June 2011 real wage growth fell by over 3% for the second year in a row. This is being caused by weak income growth coupled with higher levels of inflation. Low income growth remains an issue across the Scottish and UK economies. It is likely that stronger wage growth would have come at the expense of much reduced employment levels. In our forecasts, weak household income growth is anticipated to continue to act as a drag on spending through 2012. Reductions in the rate of inflation ease some of the pressure on household budgets, but real terms growth in income is not expected through the first two years of our forecast (2012 and 2013). As well as weaker income growth and increasing prices, government policy on reductions in benefit levels and spending will continue to impact on those more reliant on these forms of income, with potential significant consequences for household income inequality.

Movements in wealth indexes over the recent past suggest that some household wealth measures have fallen during 2011. According to the Halifax House Price index, the average value of a home in Scotland fell in 2011 by 3.5%, slightly more than the fall in house prices across the UK in that year (-2.6%). Interestingly, the fall in house prices across the UK in 2011, by this survey, contrasts with the growth seen in 2010. Looking at the quarterly series, average house prices in Scotland were down 22.7% on their 2008Q1 peak at the end of 2011. At the UK as a whole, the peak in prices came in the third quarter of 2007, and prices are currently 18.9% lower than their peak.

As a barometer of household spending, the latest figures from the Scottish Retail Consortium for sales in January 2012 were not promising. Like-for-like sales were down 2.6% on a year previously, with the largest fall in total sales for any month since 1999. These figures are perhaps affected by the VAT changes at the start of 2011, making the comparison figure unrepresentative of January last year. SRC's figures also indicate lower consumer confidence in Scotland than the UK as a whole.

Of course, retail sales are only part of household spending. The most complete picture of Scottish household consumption is produced in the Scottish National Accounts Project data, which are comparable to UK series on consumption spending. We have previously noted that consumption spending in Scotland appeared to have been growing at a slower rate than the UK as a whole (while UK consumption growth was also weak). As of the third quarter of 2011, both Scottish and UK consumption indices were

down from levels seen during 2010. The Bank of England notes that real UK household consumption is only 1% above the trough seen in 2009Q2, while by our calculations Scottish spending is 0.9% above its trough in the same quarter. Scottish consumption spending is therefore appearing to grow (marginally) more slowly in Scotland. This is shown in Figure A.

Recent movements in the households savings ratio continue to show increased savings compared to pre-recession period. The UK level of household saving as a portion of gross income in the third quarter of 2011 stands at 6.6%, slightly below the rate for Scottish households (6.8%). In the growth years of 2002-2007, the average quarterly Scottish saving ratio was 4.6%, while for the UK this was 3.8%. Taking this back further, there was little difference between the average savings ratio between the UK and Scottish savings ratio between 1998 and 2007 at 4.7% in Scotland and 4.6% in the UK. Since the start of 2008, the average savings ratio has increased by more in Scotland, with an average of 7.5%, to the UK's 6.0%.

The Bank of England's February 2012 Inflation Report suggests three reasons for an increased household savings rate post-recession:

- Expectations of lower future earnings (including lower pensions);
- Job insecurity and fears of loss of income;
- Tighter credit conditions for households.

The question remains however, why are Scottish households exhibiting a higher rate of savings than UK households as a whole? Looking at the points above, we would not expect that household credit conditions (i.e. the availability of credit) are different in Scotland compared to the UK. What might differ on this point could be the willingness of households take on credit, although we are not aware of any evidence to support this. Fears of job security may be stronger in those employed in the public sectors, with fiscal consolidation continuing over the next few years. Scotland has a larger share of employment in the public sector than the UK; therefore households as a whole may increase their savings. The Scottish Government has, however, stated that there will be no compulsory redundancies in the activities under their control. Many workers, particularly those in public sectors, will be anticipating below inflation wage increases over the coming years, and may be increasing savings accordingly.

Investment

The third quarter of 2011 saw an upturn in the growth of stocks in the UK as a whole, perhaps due to weaker than expected demand in this quarter. Business investment spending in the UK is around 15% down from its pre-recession peak, while the latest Bank of England Inflation report shows that the lack of demand continues to be the principal reason given for firms' holding back making investments. Since the credit crunch the importance of availability of finance for not making investments has increased, although its importance compared to the demand outlook has not changed.

The method used to construct figures on investment spending in Scotland has been revised in the most recent quarter. These latest data come from the Scottish National Accounts Project. Figure C shows the levels of investment spending over the period covered by the survey – from the start of 1998. Focusing on the period since the start of the recession, we see that real investment spending appears to have fallen less significantly in Scotland than in the UK as a whole. Where the most recent data suggests a sharp uptick in investment spending in Q3, this is not evident in the Scottish figures, where the rate of growth appears to have slowed (slightly) during 2011. Given these are recently released data series, we hope to return to this series in later Commentaries.

Tourism

Looking forward, survey evidence suggests a weakening of demand from overseas visitors in Q1 2012. Over the rest of 2012, the London Olympics and Paralympics is arguably the most high profile single tourism driver in the UK. It is hoped that this will encourage tourism visits into the UK, and Scotland through overseas visitors taking additional within-UK trips around the Games themselves. In aggregate terms however, the tourism expenditure related to people attending the games is likely to be small. Much of the impact of the Olympics on tourism spending found by Blake (2005) for example, comes from increases in the level of tourism to the UK before and after the games a result of raising the profile of the UK tourism offering. It might be argued that this impact would be larger for locations with lower tourism profiles, seeking to position themselves internationally alongside a global elite of destinations (which London is arguably already part of).

In addition, Blake (2005) reports a negative effect on the spending of residents of where the games are held during the games themselves as residents go out for dinner/entertainment activities less during the period of the games. If Games-related expenditures by households come from reduced savings then there could be a net-benefit from additional spending. Of course, similar issues will be likely to arise around the Glasgow Commonwealth Games in 2014, and we will return to this in more detail in a later forecast. A recent paper in the Economic Journal (Rose and Spiegel, 2011) found that there was indeed an "Olympic effect" from hosting "mega-events" (such as major international sporting events), but that this was due to a trade (export) increase, which, the authors argued, was "attributable to the signal a country sends when bidding to host the games, rather than the act of actually holding a mega-event [like the Olympics]".

Trade

At the UK level, trade contributed positively to the growth seen in 2011. Indeed, the domestic economy – consumption (public and private) and investment – are estimated to have

declined in this year. While exports grew by 4.75% in the year to 2011, this was down on growth seen in 2010. Slowed import growth contributed to the net boost from trade at the UK level.

The most frequently updated measure of Scottish exports to the rest of the world (ROW) is the Index of Manufactured Exports (IME). This survey reports changes in the real (i.e. inflation adjusted) volume of exports by manufacturing companies based in Scotland to the rest of the world. The latest figures relate to Q3 2011 (and were published on the same day as Q3 GDP figures). The latest data showed a slowing of the growth in ROW exports to 0.2% from the previous quarter. On a rolling four-quarter growth, exports increased by 2.7% (up from 2.1%). At the sub-manufacturing level, the largest contribution to ROW export growth in the last quarter, and also over the last year, came from the food, drink and tobacco sector, which increased 2.6% in the last quarter and 4.6% over the year.

The Global Connections Survey (GCS) is a less frequent (i.e. annual rather than quarterly) but more comprehensive survey (i.e. all sectors) of Scottish export activity. The latest report, published in January 2012, painted a mixed picture of export performance over 2010, compared to 2009. These data, relate to the economic picture of over a year ago. While this means that these data are not directly useful for informing the trading picture at this moment, they do provide a useful snapshot of the performance of important sectors for the Scottish economy. With exports anticipated to contribute positively to economic performance over the coming years, with reduced reliance upon domestic (i.e. Scottish) demand, this type of information is critical.

The GCS reports that Scottish international (ROW) exports rose by £355million between 2009 and 2010, and stood at £21,980million during 2010. By destination, the major markets remains the EU (supporting almost half of this external demand) and North America. The importance of Asian markets fell by £300million during the year. This is particularly disappointing, given quite significant increases over the recent past in developing markets in Asia.

The same publication also reports the value of exports between Scotland and the rest of the UK (RUK), although these are published by the Scottish Government with significant “health warnings” about the robustness of this data sample. This would appear to be another area of Scottish economic data where evidence-supported knowledge lags economic, and also political, interest by a considerable margin. Many reasons exist why the data on intra-regional UK trade is difficult to capture – no statutory obligation on firms; definitional issues of what is an “export”; the specific residence of the final consumer, etc. – so this would be no easy task. It is promising therefore that the GCS notes that Scottish Government work is ongoing regarding the identification and quantification of RUK exports.

The GCS reports that RUK exports from Scotland rose by almost £2000 million in the year to 2010, up to £44,950million during 2010. The rest of the UK therefore is responsible for over two-third of exports from Scotland. This is what we would expect for a small very open economy located next to a much larger economy, i.e. the RUK. Further, we can also suggest that Scotland’s direct exports understate the true importance of trade with the rest of the world for economic activity in Scotland. Items sold as intermediate items in the production process, or down the supply-chain of final products, would not count as exports from Scotland, but to the extent that they are sold outside the UK (and so count as UK exports) there was Scottish activity at an earlier stage.

We discuss recent and historic trends in exports from Scotland to the rest of the UK and rest of the world in Box 1.

Looking forward, the major obvious challenge to Scottish exports during 2012 and future years is the continuing unfolding of stability in the Euro Area. This economic area is the prime destination for Scottish ROW exports: seven of the top ten export markets for Scottish goods are Euro members (the others being the USA, Norway and Switzerland). A recent report on the Euro Area (Euroframe, 2011) had a central forecast for growth in the Euro Area of 0% in 2012 and 1.4% in 2013, however on the “downside” scenario of -2.1% in 2012 and -1.2% in 2013. This is a remarkable range (2.6 percentage points in absolute terms) between alternative scenarios at such a forecast horizon, but reflects the potential for a decisive downturn in the economic prospects under plausible scenarios. Indeed, while presented as alternative scenarios, the report sets these on the work of Blanchard (2011) as some of the possible “multiple equilibria – self-fulfilling outcomes of pessimism or optimism”. Continued sovereign debt fears increasingly threatening the core countries, accelerating fiscal consolidation in the core and periphery, and worries about the stability of the Euro banking system are not a recipe for stability or growth, and it would be unwise to attempt to predict with certainty the likely future of the Euro project over the coming years. On the other hand, our forecasts require us to make a case for growth in the coming years, and – relative to November’s commentary – we have revised down the growth in demand for Scottish goods from the rest of the world due to the continued worries about growth in the Euro area.

Table 1 shows the GDP growth forecasts for the main six export markets for Scottish (non-UK) exports. Growth prospects during 2012 appear poor, with only the US economy forecast to grow by more than 1.5%. The IMF forecasts a 0.5% contraction in growth in 2012 in the Euro Area, a revision down of 1.6 percentage points on their forecast from September 2011. This indicates one clear link between the rapidly changing political environment and economic outlook. Prospects in core Scottish export markets are forecasted to improve slightly through 2013, with the Euro Area forecast to grow by 0.8% (IMF) or 1.4%

Box 1: Export performance over the recent past

The figures for exports produced in the Global Connection Survey are in current prices, i.e. the values are in "nominal" terms, where the value of one pound between years will change with inflation. Small increases in nominal values for exports could be offset by increases in price levels, masking the "real" movement in the value of exports. An important adjustment is to convert this nominal series into a constant price series. This is not a straightforward task. As with previous Fraser Economic Commentaries, we have used Scottish-specific current and real price figures for manufacturing exports, alongside UK services export deflators, to estimate real growth in sectoral exports over time. These data should be considered illustrative given the data quality, particularly the lack of product specific Scottish trade deflator series for service sector exports. Where UK proxies are not appropriate, this would mean that the real rates of growth could be different from that reported here. Caveats notwithstanding, we present our results below, and begin to draw some tentative findings:

1.1 Rest of the UK exports

	Compound Annual Growth Rate (whole period)	Compound Annual Growth Rate (2002-2007)	Compound Annual Growth Rate (2008-2010)
All RUK exports	4.2%	9.9%	0.6%
All RUK manufacturing exports	0.4%	1.9%	0.6%
All RUK manufacturing exports minus electrical and instrument engineering	1.9%	4.0%	1.4%
All RUK non-manufacturing exports	5.1%	13.0%	-1.1%
All RUK service exports (above minus utilities, construction, agriculture and quarrying)	5.5%	13.4%	-0.9%

The annual growth rate of exports to the rest of the UK was 4.2% over the period from 2002 to 2010. The impact of the recession is clear: looking at the pre-recession (up to the end of 2007), and the recession period (from 2008 onwards), we see that export growth fell from an annual rate of 9.9% to 0.6%.

Breaking this down by sectoral/product exports, we see that non-manufacturing exports have provided the strong support for export growth to the rest of the UK, rather than manufacturing exports. The annual growth rate over the whole period for all service sectors was 5.5%, with a very strong growth pre-recession and actually a real terms annual average decline over the years since the recession (-0.9%). Manufacturing exports on the other hand shows a far smaller, but positive, growth rate in both periods. Removing the electrical and instrument engineering exports, which fell sharply at the start of the sample, annual average growth was just 1.9% over the whole sample. These results suggest the growing importance of service sector exports for total exports to the rest of the UK.

1.2 Rest of the world exports

	Compound Annual Growth Rate (whole period)	Compound Annual Growth Rate (2002-2007)	Compound Annual Growth Rate (2008-2010)
All ROW exports	-0.4%	-0.5%	-0.6%
All ROW manufacturing exports (IME)	-1.3%	-0.2%	-2.0%
All ROW manufacturing exports (GCS)	-3.8%	-4.2%	-2.3%
All ROW manufacturing exports (GCS) minus electrical and instrument engineering	1.3%	4.4%	-1.4%
All ROW non-manufacturing exports	6.4%	8.3%	1.3%
All ROW service exports (non-manufacturing minus utilities, construction, agriculture and	6.8%	8.9%	1.4%

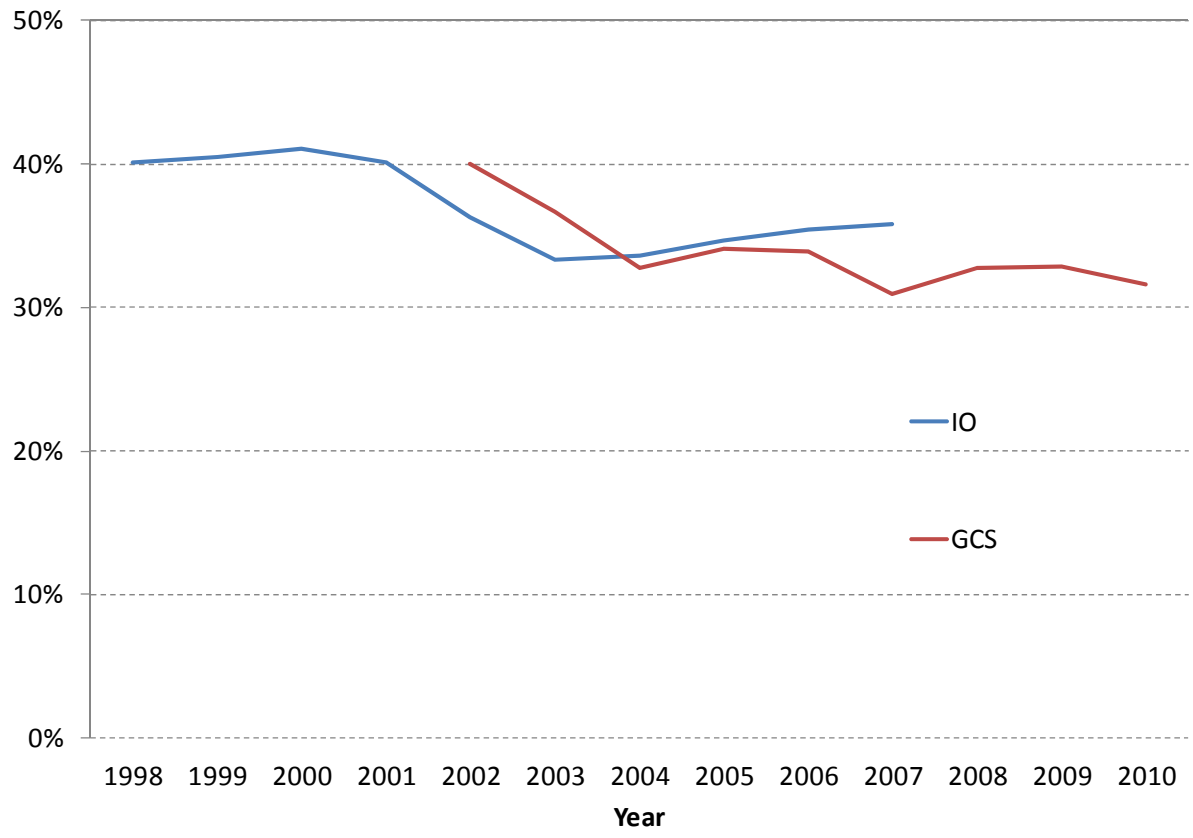
The most striking result from the same analysis of ROW exports is that all these exports appear to have reduced on an annual basis by -0.4% over the period of the sample. The same growth rate is seen in both the pre- and recession periods. Again, we see the strong performance of the non-manufacturing and service sectors in improving Scotland's export performance, while manufacturing export growth has been considerably weaker.

Box 1 (cont'd)

1.3 Relative increase in importance of rest of the UK

Another interesting feature of the GCS data was the apparent emergence of the rest of the UK as the major destination of Scottish exports, rather than the non-UK rest of the world. These data suggest that Scotland's major export market over the last decade has always been the rest of the UK, but that the importance of the rest of the UK has grown. Using the full data series (2002 to 2010) of the Global Connection Survey (GCS) alongside the same measure from the Scottish Government produced Input-Output tables series (covering 1998 to 2007), as produced by the Scottish Government, we can examine this shift through time. The results are given in Figure B1 below.

Figure B1: Share (%) of total Scottish exports going to non-UK rest of the world, 1998 to 2010



This diagram appears to show that the rest of the UK has become a more important destination for Scottish goods over the last decade. Non-UK exports from Scotland have fallen from around 40% of all exports to just above 30%. The timing of the movement appears to be slightly different between the two series, but it seems to have happened over a small number of years. For example, the shakeout occurred in 2002-2004 on the GCS measure, while the IO tables suggest 2001-2003 saw the biggest change.

Looking at the IO tables, it appears that the falling exports to the rest of the world by the Scottish electronics sector correspond entirely with this decline. These lost exports by this sector removed a significant portion of Scottish exports to the rest of the world. From 2001 to 2003, the nominal value of ROW exports from the "Office machinery and computers" sector declined from £3,950 million to £597 million. Figure B2 shows the share of total exports from Scotland which were produced by this sector between 1998 and 2007. This sector produced almost 10% of all Scottish exports in 2000, but by 2003, this had fallen to below 2%. Taking all electronics sectors exports (defined as sectors 69-75 in the IO tables) these reveal a similar pattern, declining from 15% in 2000 to 4% by 2003. As of 2007 the broad electronics sector produced only 2% of Scottish exports.

Box 1 (cont'd)

Figure B2: Exports to the rest of the world by the "office machinery and computer" sector as a share of total exports from Scotland, 1998 to 2007

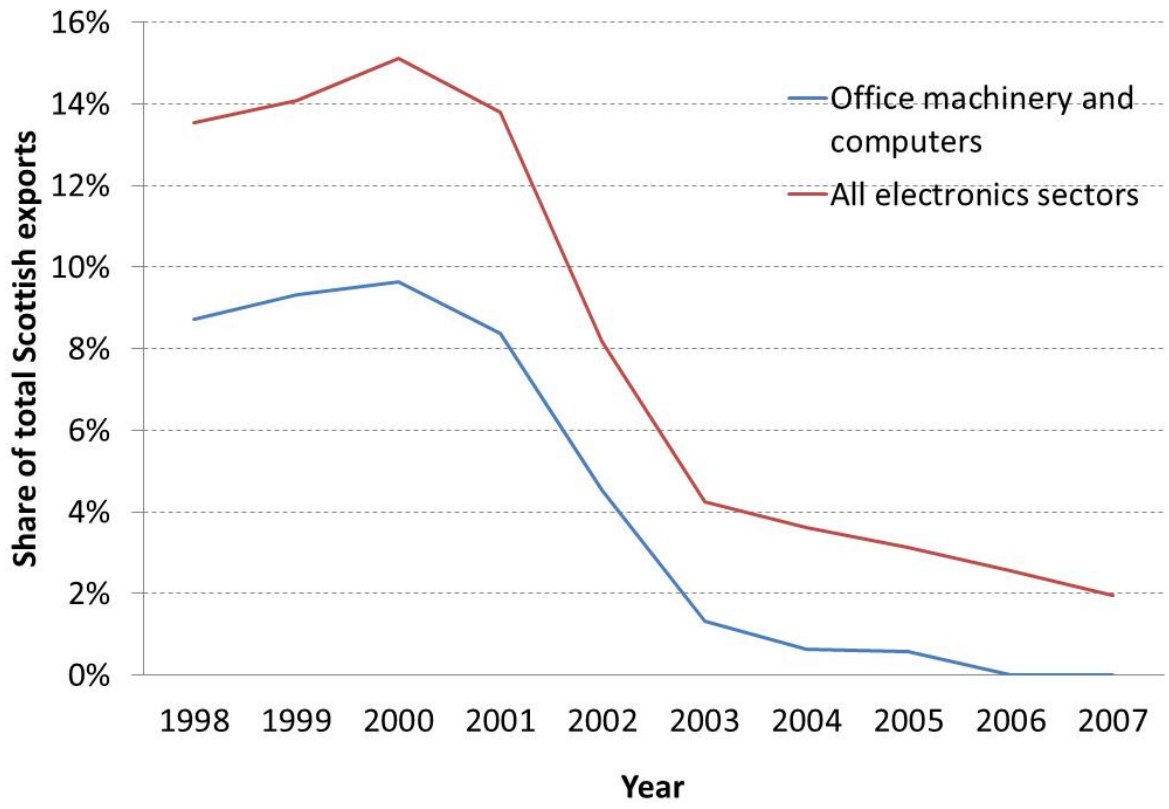


Table 1: GDP growth forecasts for 2012 and 2013 for export markets for Scottish products, plus UK, Euro area and China growth rate, including changes from earlier forecasts where available

	2012			2013		
	IMF	**Change from Sep 2011 forecasts**	**OECD**	**IMF**	**Change from Sep 2011 forecasts**	**OECD**
USA	1.8%	0.0%	2.0%	2.2%	-0.3%	2.5%
Netherlands	n/a	n/a	0.3%	n/a	n/a	1.5%
France	0.2%	-1.2%	0.3%	1.0%	-0.9%	1.4%
Belgium	n/a	n/a	0.5%	n/a	n/a	1.6%
Germany	0.3%	-1.0%	0.6%	1.5%	0.0%	1.9%
Ireland	n/a	n/a	1.0%	n/a	n/a	2.4%
UK	0.6%	-1.0%	0.5%	2.0%	-0.4%	1.8%
China	8.2%	-0.8%	8.5%	8.8%	-0.7%	9.5%
Euro area	-0.5%	-1.6%	0.2%	0.8%	-0.7%	1.4%

Sources: International Monetary Fund, World Economic Outlook (Update), 24th January 2012; OECD Economic Outlook, November 2011

(OECD). The UK picture is forecasted to improve slightly as well, with growth of around 2% predicted by both organisations.

Forward looking survey evidence on Scottish exports suggest a general agreement that export activity has slowed towards the end of 2011, particularly affecting output in manufacturing sectors. Scottish Engineering reported a downward trend in orders, while the SCBS survey – which had seen increases in export orders over the previous four quarters – saw export orders fall, with a continued decline in orders expected in Q1 2012. Across the board, business confidence in the key production sectors has weakened significantly since Autumn 2011, with continued fears about exports a primary factor.

Forecasts for the Scottish economy

The large unknowable in this forecast scenarios, as with forecasts over much of the recent past, remains the fragile political and economic state of the Euro area. At the same time, we are faced with continued weaknesses in the domestic (Scottish) economy. The last three months of 2011 are likely to have seen a fall in output, in line with earlier expectations given weak production figures. Sluggish signs of positive growth from surveys, along with weakening business confidence for orders in the first half of 2012 do not give a hugely positive outlook for the overall Scottish economy over the short- and medium-term.

The outlook for domestic demand remains weak with wages increasing at below previous rates and a continued high rate of household savings. With weak consumption spending, our forecast for household expenditure remains broadly flat (0.2%) through 2012, with small growth in 2013 and 2014.

Government (non-capital) spending is forecast to reduce in real terms over the next three years at an increasing rate as departmental cuts outlined in the CSR from Autumn 2010 are implemented. The IFS in January 2012 outlined that some 88% of planned DEL reductions have yet to be implemented. This will continue to exert a downward pressure on domestic demand. The data appears to suggest that government spending has fallen faster in real terms in Scotland than the UK as a whole, although there are some question marks around the measured expenditure contribution of government spending at the UK level. Where this relates to redundancy payments, for instance, it is unclear if these charges would show up in the data at the regional level, or if they would be processed within the Westminster “centre” (and so reveal themselves solely in the UK data, even for Scottish-located “reserved” employment). We would expect that any such payments would be included within the Scottish spending component. We anticipate an increasing rate of government spending reductions in Scotland through to the end of our forecast horizon in 2014.

As mentioned earlier, prospects for Scottish exports remain hugely uncertain. Growth prospects in the rest of the UK – Scotland’s largest export market – remain low. The OBR forecasts 0.7% growth in 2012, but this is above the average of new independent forecast of 0.4%. The OBR forecasts date from November and so are before any of the most recent developments in the Euro Area. Scottish export prospects to the rest of the UK are strongly correlated with UK economic growth, so weak growth is likely to be bad for Scottish exports. The continued reliance of Scottish non-UK exports on the economies of the Euro Area and EU, and falling sales to Asian markets in 2010, show the difficulties in expanding this critical part of Scottish output. We forecast that exports to the rest of the UK and rest of the World from Scotland grow in each year from 2012 to 2014 at an increasing rate, but that they only return to broadly trend growth by the end of the forecast horizon.

Prospects for investment growth in Scotland through the first half of 2012 appear weak as inventory growth at the UK level – for which more timely data is available – suggests a lower rate of stockbuilding in important sectors. Public infrastructure spending is likely to be critical for short-term developments, but is around one-third of all investment spending in a typical year, so the importance of private investment is clear. The OBR forecast a divergence in these (public and private) investment series as public austerity is partially offset by rebounding private sector investment.

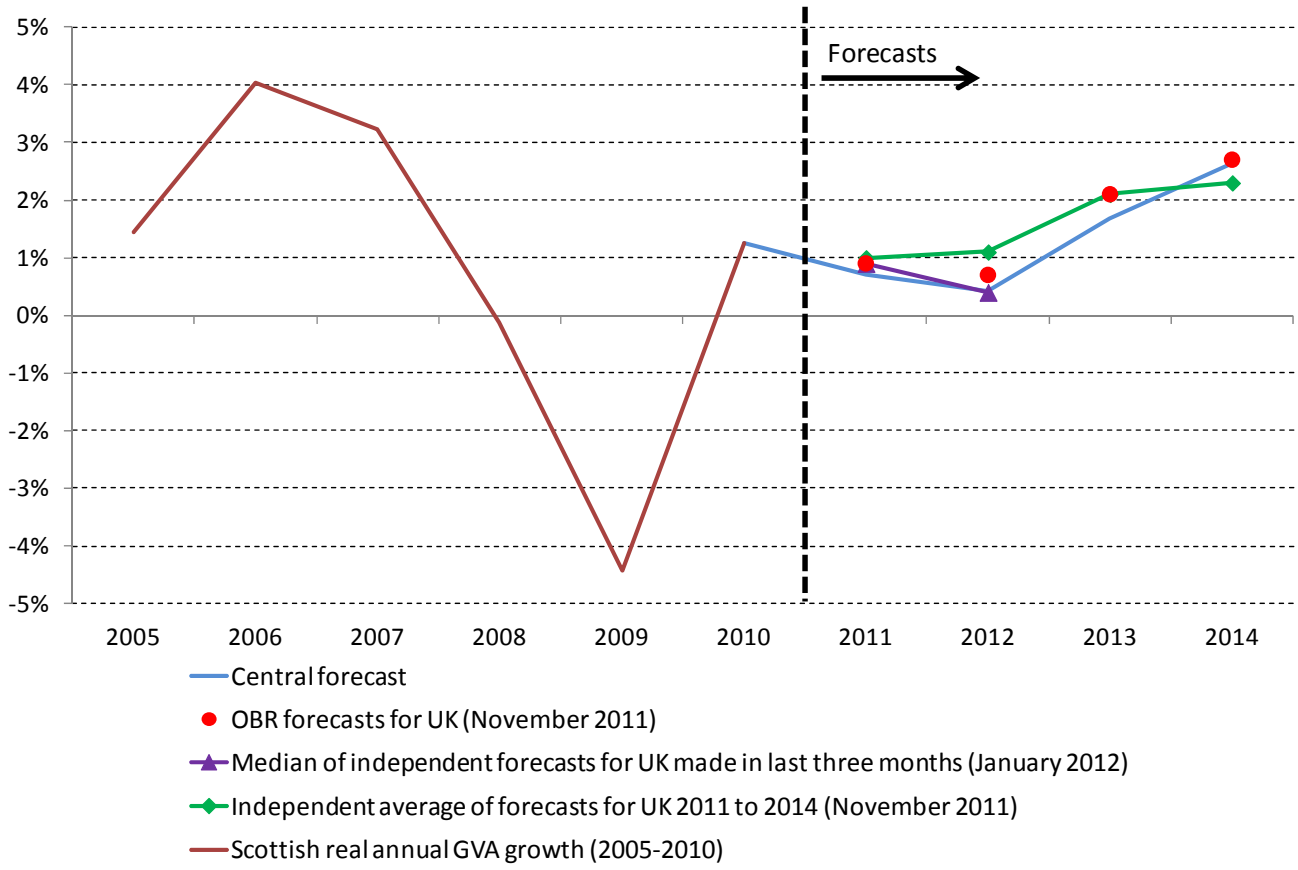
Results

We have extended our forecast horizon out to 2014. This means that we have a forecast horizon of over three years, as the final data for 2014 will not be known until April/May of 2015. As previously, we are forecasting year-on-year real growth in Scottish Gross Value Added (GVA).

The aggregate forecasts for growth in Gross Value Added in Scotland for 2011, 2012, 2013 and 2014 are shown in Figure 1. This figure also shows (for comparison only) the forecasts for the UK over the same period from a number of sources. Firstly, we show the forecasts by the Office for Budgetary Responsibility (OBR) produced in November 2011. Secondly, we show the median of new forecasts for the UK in 2011 and 2012 made by independent forecasts in the last three months. These are collated and produced monthly by the UK Treasury. Thirdly, we show the longer-term forecasts for the UK produced every three months by the Treasury, including forecasts for 2013 and 2014. Note that the OBR forecast of 0.7% for 2011 (made in November 2011) was itself revised down from 1.7% in the March of that year.

We have raised our central forecast for growth in 2011 up slightly from 0.4% to 0.7%. The increase in output measured for the third quarter of 2011 was stronger than expected (a 0.5% increase), and broadly tracked the UK growth in that quarter. This upward revision has brought our forecast in line with our earlier forecast from June 2011, where we forecast 0.8% growth during 2011. In March 2011 we had forecast annual growth of 1.0% in 2011. Our new forecast for 2012 of 0.4% would not be inconsistent with one or possibly two quarters of negative growth through 2012.

Figure 1: GVA growth for Scotland, 2011 to 2014 and comparison UK forecasts, annual real %



Indeed the Bank of England's Governor, Mervyn King, noted the possibility of a "zigzagging" phase for growth over the coming year.

In November 2011, we forecast growth in 2013 of 1.6%, so our latest forecast is revised up slightly. This is the first instance that we have forecast growth in 2014. The forecasted growth path from the third quarter of 2011 through to the end of our forecast horizon, and the implications for the level of Scottish GVA, is discussed in Box 2.

As well as forecasting the aggregate shifts in the Scottish economy, we present our forecast by broad industrial grouping. Table 2 gives real growth in sectoral GVA for the Production, Services and Construction sectors.

Table 2: Growth in the Scottish economy, 2011 to 2014, % change from previous year

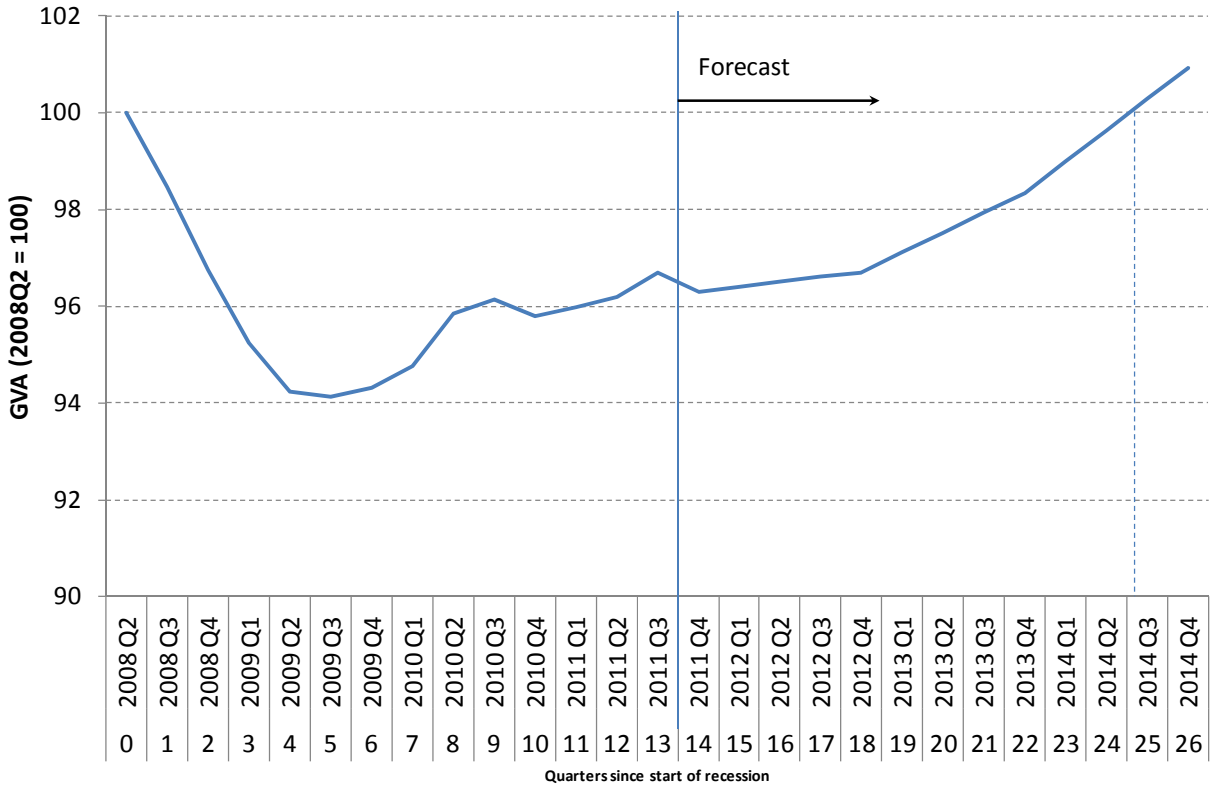
	2011	2012	2013	2014
Gross Value Added	0.7%	0.4%	1.7%	2.6%
Production	2.0%	1.0%	4.0%	6.0%
Services	0.4%	0.3%	1.1%	1.9%
Construction	0.4%	0.3%	1.1%	1.7%

As previously explained, the weak outlook for domestic demand through the next few years means that sectors which are principally domestic-facing, i.e. serving Scottish-only customers, are expected to continue to bear the consequences of slower household expenditure growth and declining real government spending. The services sector is forecast to see a relative slowdown in growth in 2012 compared to 2011, of 0.3% and recover to almost 2%

Box 2: A return to pre-recession real GVA could take over two and a half years

Taking our new forecasts we can predict at what point the pre-recession peak of real GVA will be reached. As others have commentated, whether or not growth is above or below peak, or indeed the UK rate, is slightly academic so long as the economy remains around depressed levels. Figure B1 gives the path of GVA for Scotland which is consistent with our (central) forecasts for growth. We have taken the starting point of this chart as the end of Q3 2011 and estimated a final quarter growth rate consistent with our new 2011 forecast. While we only forecast annual growth, and not quarter by quarter, we have assumed that each quarter grows at a rate consistent with its share of the annual growth rate.

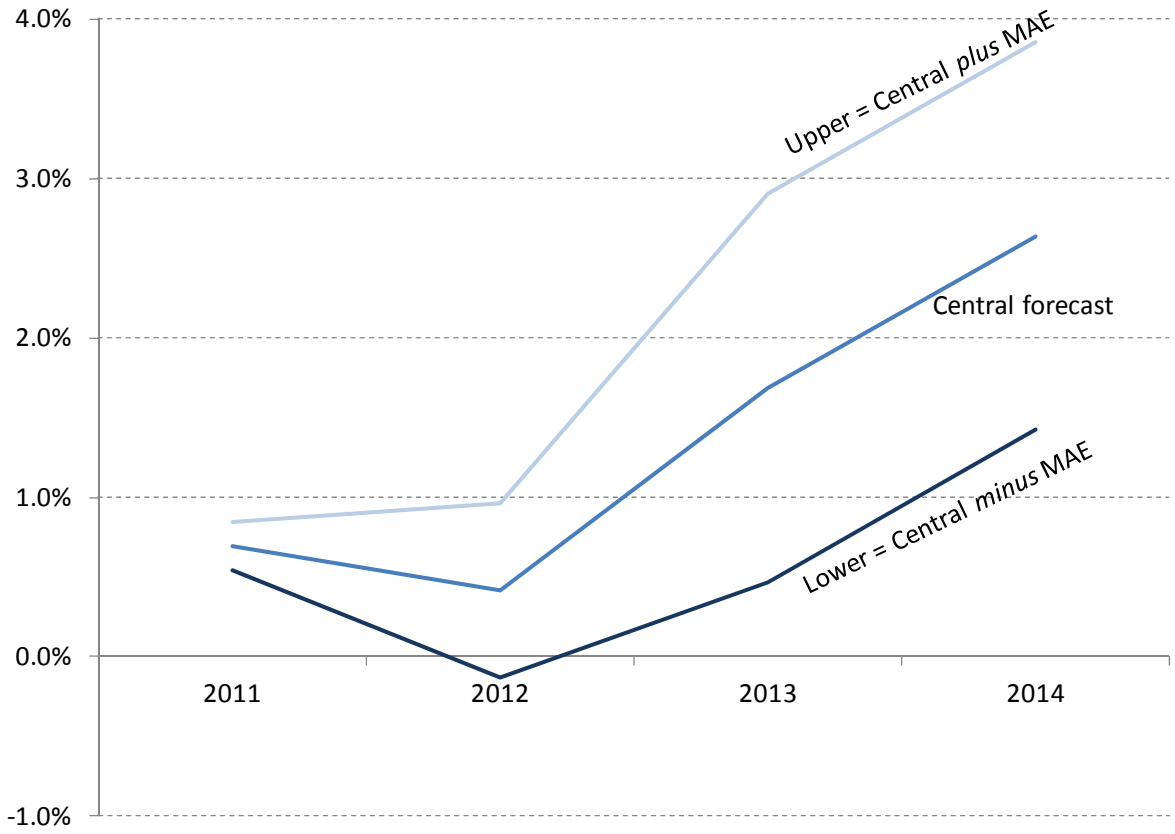
By these calculations, in the third quarter of 2014 Scottish GVA will return to its pre-recession peak, just in time for the Commonwealth Games in Glasgow (23rd July to 3rd August 2014). Recall however that this is simply making up the output lost during the recession, i.e. bring it back to the Q2 2008 level. The gap between the path of GVA without the recession and the actual path will demonstrate the size of the output lost during what has been termed the "Great Recession".



growth in 2014. A similar path is forecast for the construction sector, although this sector is likely to respond quickly to any upswing in business investment. The production sector is forecast to see the strongest growth over the coming years. We are forecasting that growth in the production sectors in 2012 will be only half (i.e. 1%, rather than 2%) its growth during 2011 as export markets for Scottish products see possible falls in output. In the later two years of our forecast window we expect to see a return to stronger export growth.

As reported in the last Commentary (Allan, 2011) we can use our estimated forecast errors to show ranges around our central point estimates. We roll this forward in this commentary and use forecast errors from the "Spring" forecasts we evaluated. There were three forecasts made in the Spring of the year that were identified in this work: the spring after the year has finished but before the GVA figures are released (we called this the "following Spring", as its forecast related to the year completed); the forecast made in the Spring of the year that the forecast relates to, and; the forecast made in the spring of the year before the year it relates to. In this instance therefore, these three forecast horizons refer to the growth forecasts for 2011, 2012 and 2013 respectively. The measured Mean Absolute Errors for the spring forecasts and the first release estimates of GVA were 0.153 percentage points, 0.548 percentage points and 1.216 percentage points, respectively – with the forecast error increasing as the forecast horizon lengthens.

Figure 2: GVA growth in Scotland in central case and possible errors around forecasts for different forecast horizons



These MAE estimates are used to give ranges around the point estimates we predict for growth in each year to 2014. For 2014 we assume that the forecast error will be no larger than that for the spring of the year before (i.e. 2013's forecast), while in practice this is likely to underestimate the forecast error at this distance. The estimated ranges around our central case are given in Figure 2. Figure 3, Figure 4 and Figure 5 give the GVA changes for the Production, Services and Construction sectors respectively in the central, upper and lower cases.

Employment

The most recent data for the labour market in Scotland indicates that in the final quarter of 2011 (i.e. October to December 2011), employment fell by four thousand, while (ILO) unemployment increased by sixteen thousand, to stand at 2,458,000 and 231,000 respectively. The employment rate of those of working age fell by 0.4 percentage points to 70.7, while the ILO unemployment rate for the same group rose by 0.6 percentage points to 8.8%. The increase in the rate of unemployment is the largest such increase since the first quarter of 2010, and brings the unemployment rate above its earlier peak since the 2008-9 recession began. The unemployment rate is now equal to what is was in the final quarter of 1996. The rate of those of working age economically inactive remained constant at 22.5%. Detailed commentary on developments in the labour market are detailed in the Labour market section of the Fraser Economic Commentary. The unemployment rate of young people remains a prime concern for forecasts of employment and unemployment in Scotland, as does an increasing duration of those individuals receiving Jobseekers Allowance (no such duration statistics are available for ILO unemployed). There is evidence from previous recessions that the longer term unemployed have greater difficulty getting back into work, while increasing unemployment on young people is a growing social and political, as well as economic, issue across the developed world.

The most recent data on employee jobs date from Q3 2011 and indicate that there were 2,272 thousand employee jobs in Scotland. This was down 11 thousand on the previous quarter, and down 23 thousand on the end of 2010 total. The employee jobs series has been revised slightly since our last commentary, with the number of employee jobs in Scotland in the second quarter of 2011 being reduced from 2,292,200 to 2,282,600 (down almost ten thousand).

Given the now lower level of employee jobs in Scotland, we are revising down our forecasts for employee jobs at the end of 2011. In November we forecast that there would be 2,299,000 jobs at the end of 2011 in Scotland. We now forecast that there will be 2,254,000 jobs in Scotland at the end of 2011 (a loss of 40,400 jobs during 2011).

Figure 3: GVA growth forecast in Production sector in central, lower and upper cases, 2011 to 2014

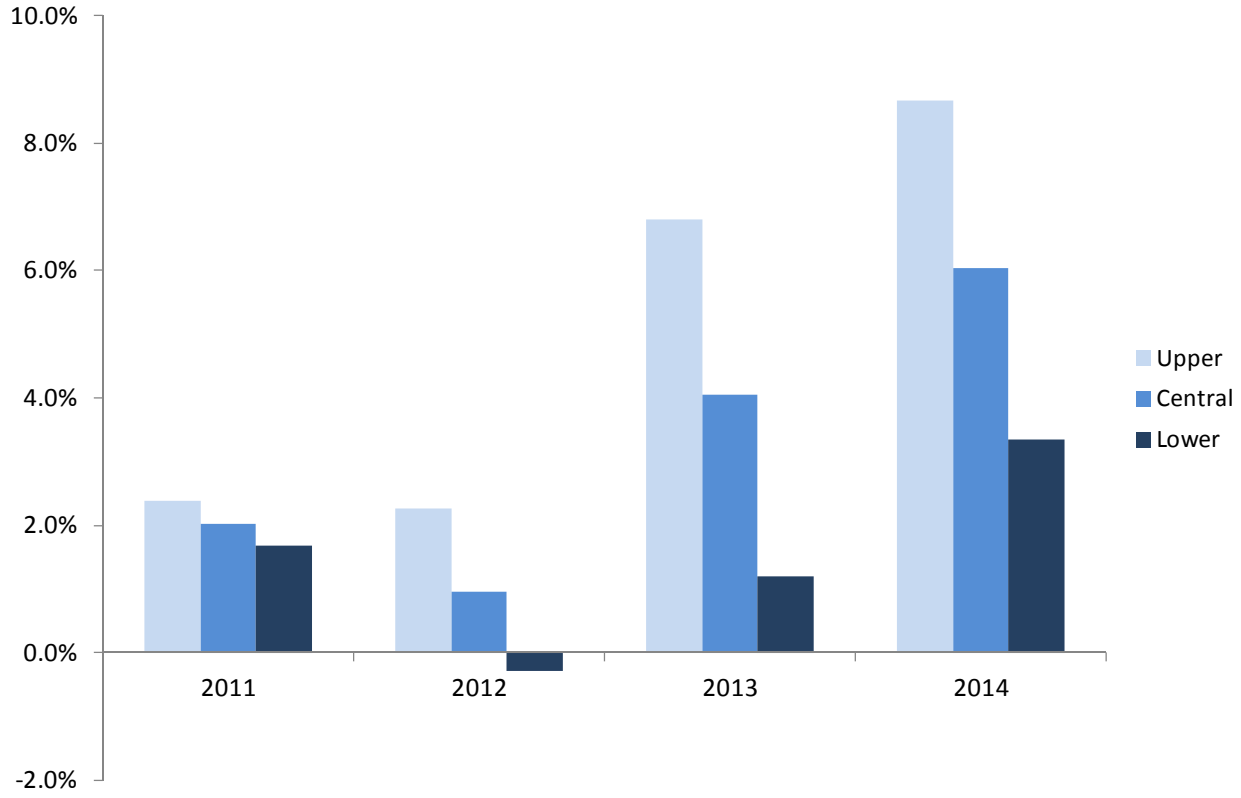


Figure 4: GVA growth forecast in Construction sector in central, lower and upper cases, 2011 to 2014

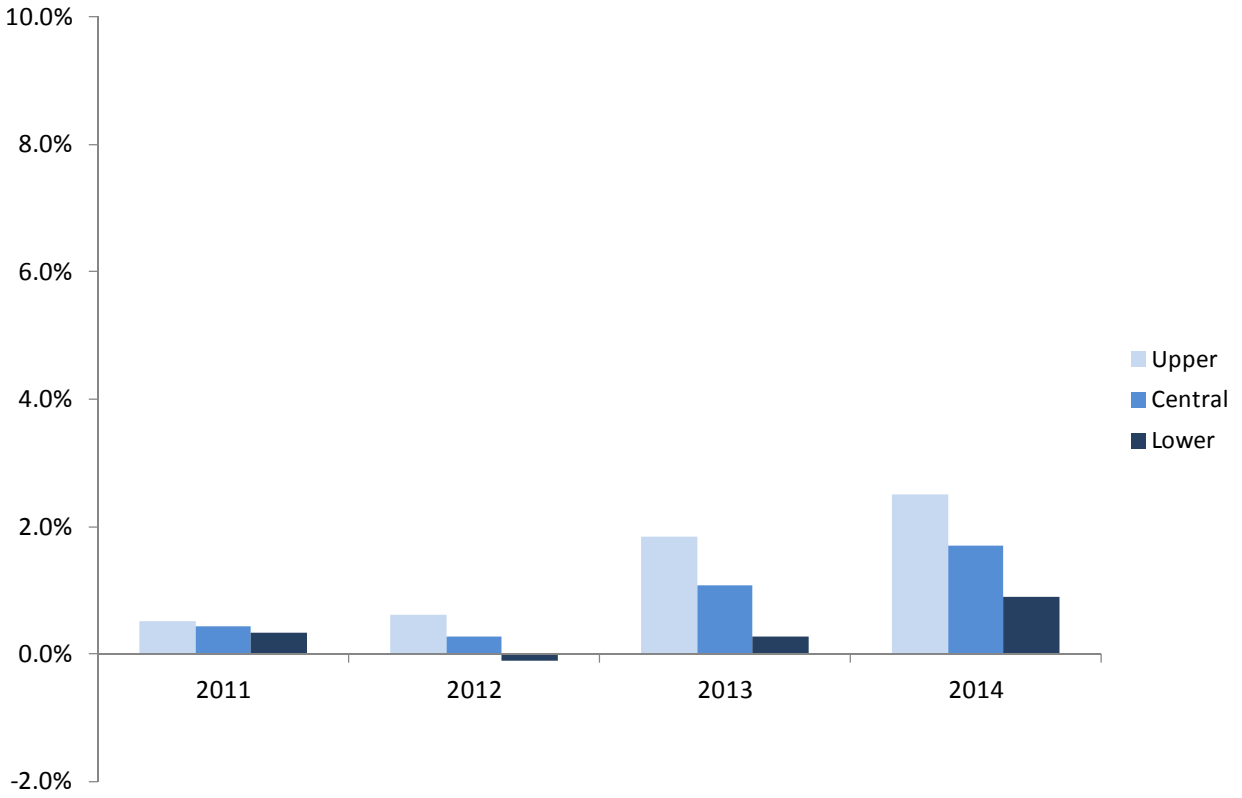


Figure 5: GVA growth forecast in Services sector in central, lower and upper cases, 2011 to 2014

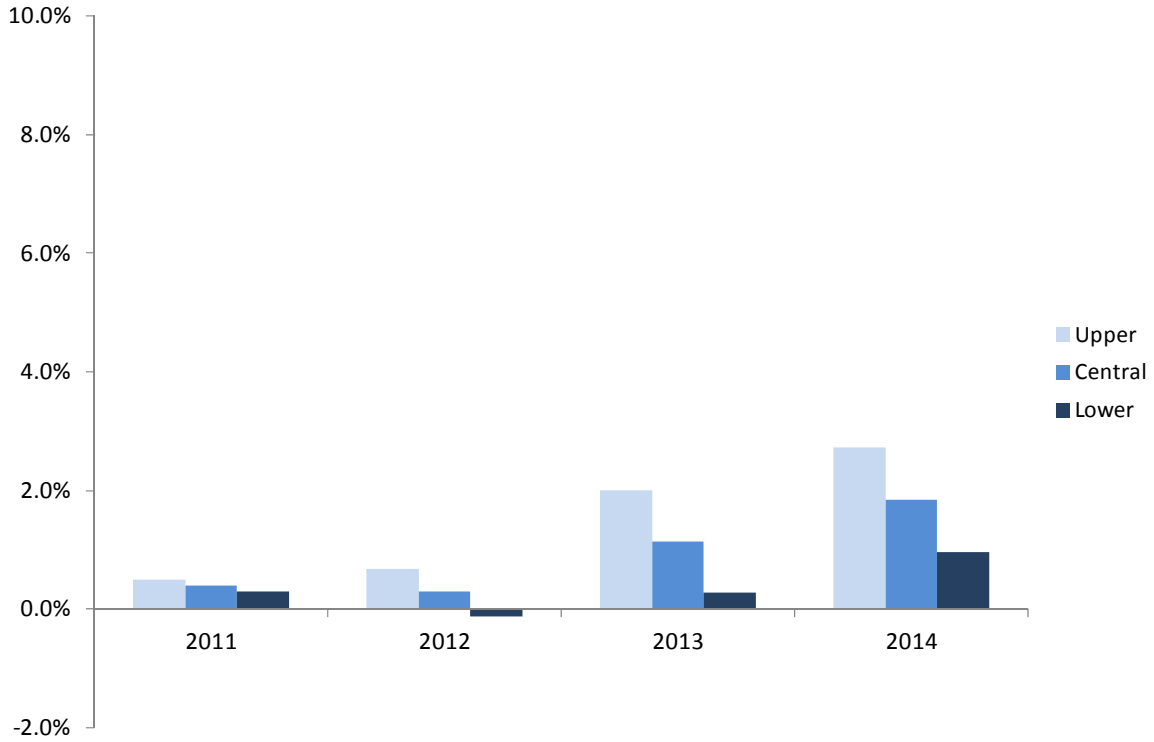
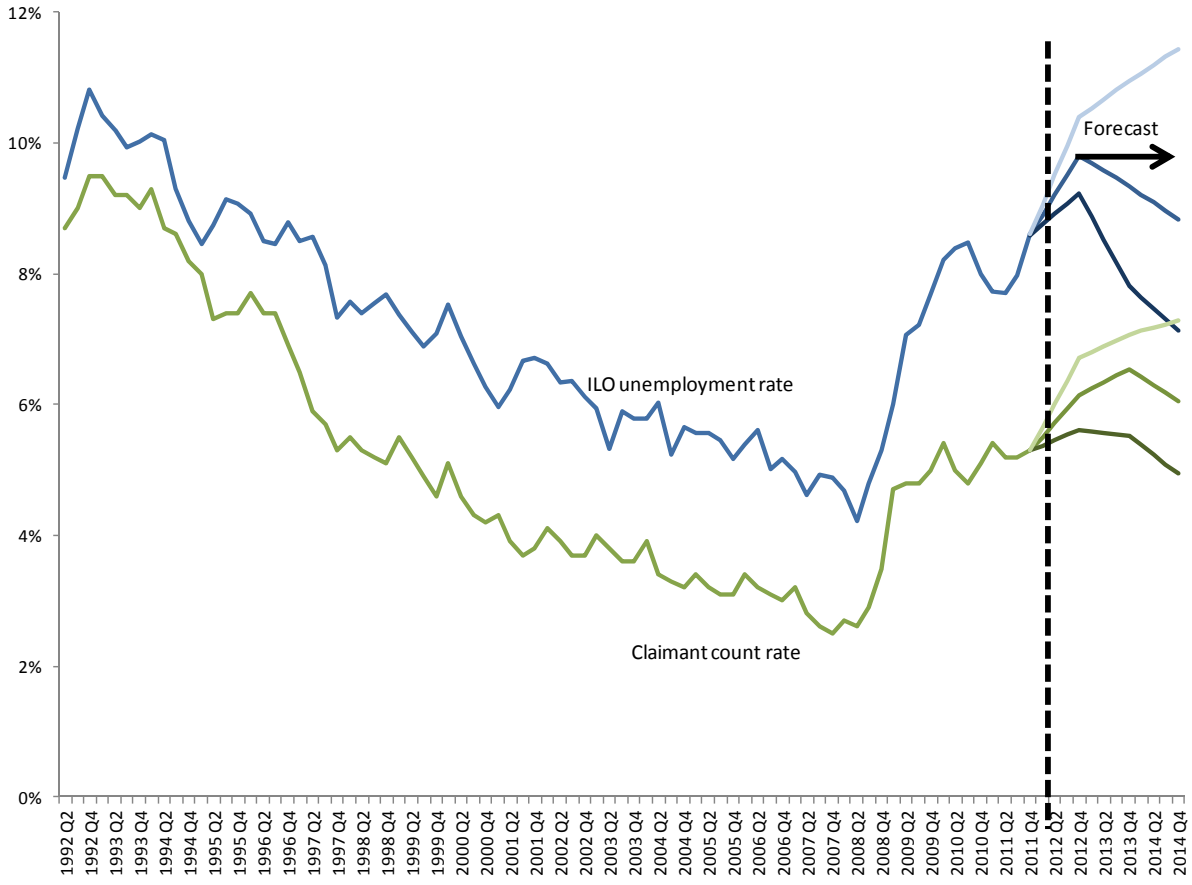


Figure 6: Scottish ILO and claimant count unemployment rate, history and forecast



Our forecasts for employee jobs, including a breakdown between broad sectoral groups, are shown in Table 3. The number of employee jobs in Scotland is forecast to decline during 2012 by just less than 16,000 jobs. Within the sectors, however, we are forecasting a reduction in jobs in the service sectors of over sixteen thousand jobs. Public sector reductions in employee jobs are forecasted to be around 7 thousand over the year, while there are also forecast to be reductions in jobs in Retail and Wholesale. Within the service sectors however, we do not forecast declines in job numbers, with increases in employment in Business Services sector. Through 2013 and 2014 we forecast increases in employee jobs in our central forecast, with annual increases of over 23 thousand and 38 thousand respectively. At the broad sectoral level we forecast employment increases, however, as in 2012 we forecast a "rebalancing" of employment within the services sectors towards non-public activities as public spending reductions continue. Construction employment is forecast to increase in both 2013 and 2014 as spending on (private) investment projects returns as confidence in the recovery returns. The employee jobs forecast consistent with our upper and lower forecasts are presented in Table 4.

Our employee jobs forecast are for lower jobs numbers than previous forecast, with our November 2011 forecast seeing (slightly) positive annual jobs growth in 2012. This more negative outlook for jobs is down to two major factors.

Firstly, the jobs market appears to have significantly weakened through the latter half of 2011, with increasing unemployment and falling employment. Combined with much of the public sector employee jobs reductions still to materialise in the data, we cannot ignore the possibility of further falls in the jobs series. Secondly, data revisions show there to have been a more significant jobs reduction in the early half of 2011 than was previously observed. It takes the jobs numbers longer to recover to their earlier (high) levels as they are starting from a lower base than was previously assumed.

We should caution that these jobs data themselves appear to be uncertain and therefore potentially subject to revision. The data on employee jobs for Scotland appear to suggest an increase of almost 45 thousand jobs in the "Health, social work and care" sector since the end of 2010. While these data are noted by ONS to be "unreliable", they are included in the total for employee jobs in Scotland. Such an increase in activity in this sector does not appear in the public sector jobs series – and any switching of classification, e.g. from public to private, would not show up as an increase in overall jobs numbers in these data. This suggests that further revisions are likely. Such revisions could further revise down the level of employee jobs in Scotland. It is hoped that the uncertainty around this jobs series can be resolved quickly as it has repercussions for the aggregate level of jobs in the Scottish labour market.

Table 3: Forecasts of Scottish employee jobs (000s) and net change in employee jobs in central scenario, 2011 to 2014

	2011	2012	2013	2014
Total employee jobs (000s), Dec	2,254	2,238	2,261	2,299
Net annual change (jobs)	-40,400	-16,000	23,200	38,000
% change from previous year	-1.8%	-0.7%	1.0%	1.7%
Agriculture (jobs, 000s)	32	32	33	35
Annual change	-550	300	950	1,900
Production (jobs, 000s)	220	222	233	248
Annual change	-3,950	2,150	11,250	15,400
Services (jobs, 000s)	1,869	1,853	1,861	1,878
Annual change	-33,500	-16,150	8,250	16,800
Construction (jobs, 000s)	133	131	134	138
Annual change	-2,400	-2,250	2,750	3,950

Notes: Absolute numbers are rounded to nearest 50.

Unemployment

We present our forecasts for unemployment in Scotland between 2011 and 2014 in central scenario in Table 5. We report both the "headline" unemployment measures, i.e. the measure used by the International Labour Organisation, as well as the numbers receiving unemployment benefits. The ILO measure is preferred as it gives a more full indication of the level of labour available for work in the economy, and so is a better measure of the level of spare labour capacity. It has been an interesting feature of the recent recession that the ILO measure of unemployment has increased significantly in both absolute and level terms, but the claimant count has responded more slowly. For example, the unemployment rate (those unemployed of working age as a portion of the working age economically active) on the ILO measure at the end of 2011 was 8.8%, up from 8.2% at

Table 4: Net employee jobs growth in Scotland in central, upper and lower forecasts, 2011 to 2014

	2011	2012	2013	2014
Upper	-37,400	-4,800	47,250	63,750
Central	-40,400	-16,000	23,200	38,000
Lower	-43,450	-27,700	-1,850	12,150

Notes: Absolute numbers are rounded to nearest 50.

Table 5: Forecasts of Scottish unemployment in central forecast, 2011 to 2014

	2011	2012	2013	2014
ILO unemployment	231,200	265,250	253,950	234,300
Rate1	8.8%	9.8%	9.3%	8.8%
Claimant count	141,500	164,450	177,750	166,350
Rate2	5.3%	6.1%	6.5%	6.1%

Notes: Absolute numbers are rounded to nearest 50. 1 = rate calculated as total ILO unemployment divided by total of economically active 16+ population. 2 = rate calculated as claimant count divided by the sum of claimant count and total workforce jobs. The latest labour market figures are detailed in the Labour market section of the Fraser Economic Commentary.

Our forecasted levels of unemployment for the end of 2012 have been revised up from those made in November 2011, largely due to the worsening outlook in the Scottish labour market. Weaker than expected employment growth and increasing unemployment rates appear to suggest that the labour market in Scotland is underperforming compared to other regions across the UK. Our forecast for unemployment on the ILO measure at the end of 2012 is now 265,250, up 34 thousand from the level seen at the end of 2011. As with our last forecast, we are expected the unemployment position to improve through 2013, and are now forecasting unemployment at the end of that year of 253,950.

As discussed earlier, we have some concerns about the reported employee jobs series perhaps overestimating the growth through 2011. If these are subject to later revisions, and removed from the series, then the employment levels could be significantly worse than the current statistics suggest.

We are forecasting that the rate of unemployment at the end of 2012 will be 9.8%, up significantly from our earlier forecasts. It appears from the latest data that employment growth has been weaker in Scotland than other regions, reducing the pull of labour into employment. We show the history and forecasted values for the ILO unemployment rate and claimant count rate from 1992 to 2014 in Figure 6.

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Review of Scottish Business Surveys

Overall

Well into January 2012 surveys of Scottish business, in common with UK and European surveys, continued to highlight ongoing and deepening concerns as to the sovereign debt crisis in the eurozone. These, together with continuing fears of recession, with more signs of a slowdown both in the UK and internationally, forecasts of lower rates of growth in 2012, continuing consumer insecurity and pressures on household spending continued to dampen business confidence and activity. However, amongst the latest UK wide surveys there are some tentative suggestions that activity, outside the construction and retail sectors, was lowest in October/November, as reflected in the fourth quarter UK results, but has picked up since then. The latest UK PMI for January reported an increase in the service sector, at the fastest rate since March 2011. But it remains unclear if this echoes last year, with good survey figures for the first quarter, but fading later in the year as the headwinds facing the UK economy remain, or represents the first signs of a more permanent upward trend.

Both the Lloyds TSB Scotland Business Monitor (Q4 2011) and the Scottish Chambers' Business Survey (Q4 2011) noted the signs of the fragile recovery in the first half of 2011 were less evident by the end of 2011. The Business Monitor indicated that the already muted recovery in the Scottish economy had stalled. 'There is every indication of an already low recovery slowing further to the point where growth is negligible or non existent.' The Scottish Chambers' survey noted 'demand remains weak as a combination of uncertainty, limited access to capital, reduced household income limits business activity and restricts plans for the future. The continuing concerns as to the future of the eurozone, the impact of government spending cuts and reorganisation of public services continue to adversely influence both activity and sentiment in Scotland and in the rest of the United Kingdom. 'It concluded, at the beginning of 2011 we noted 'Rising price pressures and weak demand seem set to continue in the service sector, for many Scottish businesses the combination of limited improvements in turnover, rising costs, pressures on margins and declining trends in profitability will pose real problems in 2011' at the end of 2011 we see little evidence in the results to change this view, if anything, our concerns for 2012 are greater and threat of recession more apparent.

Oil and Gas services

Through much of 2011 international prospects remained positive with expectations of increased capital spending on both exploration and production with continued expansion of deep water reserves and unconventional sources. However, the International Energy Agency noted that oil demand fell for the first time since the 2008 – 2009 global financial crises, a reflection of the slowing down in the major economies and a relatively mild winter. Once again expectations as to demand is affected by political uncertainties in the gulf, most notably the threat by Tehran to close the Strait of Hormuz, the EU ban on Iranian imports and the downside risks to the global economy and hence to oil demand.

UK Government data suggest that the number of exploration and appraisal wells started in Q3 2011 declined to 12 compared to 21 in Q3 2010, and Deloitte reported offshore drilling levels falling to the lowest level since 2003, however, these figures masked the approval of a larger number of significant development projects in 2011. A number of longer term reviews remain positive as to the level of activity in the UKCS.

Within the UK confidence amongst operators and contractors remained stagnant, with little change evident in the first three quarters of 2011 (Oil and Gas UK Index Q3 2011). Both the Oil and Gas UK Index and Aberdeen & Grampian Chambers' 15th Oil and Gas Survey (November 2011) reported respondents' concerns focussing on wage rate escalation (higher than the UK average), cost inflation and staff shortages.

Production

Respondents from the Lloyds TSB Business Monitor (Q4 2011) reported that export activity appeared to have been severely affected by the global slowdown and the sovereign debt crisis in the eurozone economies and, as a consequence, their assessment of prospects over the next six months has deteriorated. Production firms were marginally less pessimistic than services with a net balance of -12% compared to services with a net balance of -14%. Expectations for the volume of repeat business over the next quarter fell to an overall net balance of -11% compared to -5% of the previous quarter and the -4% of the same quarter one year ago. Expectations for the volume of new business are slightly better at -7%. This is only marginally worse than the -6% of the previous quarter and the -5% of the same quarter one year ago.

Manufacturing

The Index of Manufactured exports for the third quarter of 2011 indicated that exports grew by only 0.2% (compared to 1.1% over the second quarter)

and on an annual basis grew by 2.7%. Drink, Metal Products, Other Manufacturing and Mechanical Engineering registered rises over the quarter. Whilst most business surveys differed in their interpretation of trends, there was more agreement in surveys in the final quarter of 2011 of a slowing down in activity. The Purchasing Managers Index (PMI) conducted by The Bank of Scotland concluded that the Scottish economy witnessed a slowdown in December and a pickup in the services sector compensated for falling output and export orders from a manufacturing sector affected by the slowdown in eurozone economies. Employment prospects in manufacturing continued to look favourable during September. However, surveys for the first two months of 2012 have been slightly more positive.

Scottish Chamber of Commerce Business Survey (SCBS) firms reported that business confidence remained low and weakened throughout the second half of 2011; and similarly the Scottish Engineering Review in its fourth quarter survey outlined that business confidence has now become negative. Similarly the CBI Industrial Trends Survey for Q4 2011 reported that business optimism had 'withered' to its lowest level for three years.

Trends in total new orders became negative for respondents to The Scottish Engineering Review and SCBS firms reported that the trend in total new orders again eased in quarter four and the upward trend in total new sales ended. The trends in orders remained negative for the third consecutive quarter for CBI respondents. For SCBS firms the outturn in total orders was worse than had been expected, the rising trend in export orders, a feature of the past four quarters, ended and respondents now anticipate a slight easing in export orders over quarter one 2012. The Scottish Engineering review also reported a downward trend in export orders although in general exports held up amongst larger companies.

The CBI reported that for the first time in three years most firms intend to reduce expenditure across all four investment indicators. SCBS firms claimed that although continuing to rise, trends in investment in plant/machinery remained weak during quarter four for a net balance of firms. New investment was again mainly directed towards replacement or to improve. Capital investment plans among respondents to the Scottish Engineering Review rose for the sixth consecutive quarter. Small and medium companies remained more positive whereas large companies reported a flat trend.

Employment trends eased among SCBS and CBI firms, although two thirds reported no change and remained upbeat for respondents to the Scottish Engineering Review.

Construction

Scottish Chambers' construction respondents noted that for the fourth quarter of 2011 business confidence remained weak compared to a year ago although, given the harsh weather conditions at the ends of both 2010 and 2011, comparisons are difficult. The latest Scottish Construction Monitor conducted by the Scottish Building Federation members (SBF) for Q3 2011 reported that the general confidence rating declined by 13 points following a period of rising confidence, and a further decline was reported in Q4 together with weak trends expected for 2012. They are attributing the decline to the prospects of significant cuts in public sector spending coupled with a stagnating private sector. Similarly the Construction Industry Training Board in their report, Construction Skills concluded that the strong recovery seen in the Scottish construction industry in 2010 has proved to be short-lived, with an estimated decline of 3% in output for 2011 in real terms.' The reason cited for this is the lower than anticipated activity in the private sector combined with the depressed public sector brought about by problems in the eurozone countries and the levels of debt. The report argued that given the scale of public expenditure cuts the public construction sectors held up in 2011 better than might have been expected.

Scottish Chamber respondents reported that strong downward trends in orders had been anticipated for the fourth quarter of 2011, but worryingly the outturn was worse than had been expected. The decline in new contracts is expected to ease in Q1 2012, but it is unclear as to whether this is a pickup of work emanating from the series of winter storms or the beginnings of a recovery in activity. Over 80% of Chamber respondents reported working below capacity, and cash flow trends, turnover and profitability are all expected to be weak over the next 12 months together with continued pressure on margins. Average capacity used, at 75% was marginally lower than Q3 although was higher compared to a year ago, when activity was disrupted due to the adverse weather. The Construction Industry Training Board indicate that the concerns over prospective growth in the UK and Scotland will affect levels of private investment, therefore stunting growth in the private housing, industrial and commercial sectors in the short term. This, combined with likely public expenditure cuts will hit the public housing and public non-housing sectors hard, and the outlook for the house building sector is muted. The Construction Skills report is forecasting 2012 as another year of declining output overall with growth not expected to return to the sector until 2013.

Scottish Chamber firms reported that the downward trend in employment accelerated in Q4 and that once again no recruitment difficulties were evident. The

Scottish Construction Monitor focused on the recruitment of apprentices and concluded that firms are anticipating recruiting few apprentices over the course of 2012. Construction Skills, on the other hand, forecast that construction employment in Scotland is expected to grow at an annual average rate of 1.1%.

The service sector

The Lloyds TSB Scottish Business Monitor (Q 4 2011), reported continued weak trends in terms of the volume of new business (both new and repeat business) and expect little change to these trends over the next six months.

Retail distribution

As we have noted in earlier Commentaries recognition of the structural changes affecting the sector is critical in understanding the trends reported in retail surveys. A combination of a continued rise of internet sales (both with delivery and or collection at store bases), drift towards out of town centres and away from secondary city areas and increased price competition between the major retailers have contributed to changes in the high street shopping landscape, with slower growth in some areas but declines in others. Whilst the Retail Sales Index for Scotland Q4 2011 noted the volume of retail sales grew by 0.7% in Q4 2011 and by 0.7% annually (seasonally adjusted). The value grew by 0.8% in Q 4 2011 and by 3.5% annually (both at constant prices), both the Scottish Retail Consortium and retail respondents to the Scottish Chambers' survey reported harsh trading conditions. The Finance Secretary, in commenting on the Retail Sales index figures, suggested this reflected stronger consumer confidence in Scotland compared to Great Britain, rather than the ongoing structural changes.

In contrast both the Scottish Retail Consortium and Scottish Chambers' retail respondents reported poor sales trends through the fourth quarter. Weak sales trends had been reported by the Scottish Retail Sales Monitor through much of 2011. Sales in November 2011 were 1.3% down on November 2010 (when they had increased by 3.4%) The Scottish Retail Consortium noted 'This was the worst fall in total sales for any month since the survey began in 1999. Like-for-like sales were 2.1% lower than a year ago, the worst since August and the sixth decline in the past seven months'. Evidence of considerable discounting and extensive promotions was evident in November and concerns as to weak sales trends in December were widespread with harsh retail conditions widely forecast.

Comparisons between December's 2011 and 2010 sales reported by the Scottish Retail Sales Monitor were problematic given the marked differences in the weather. Sales in December 2011 whilst up 1.6% on December 2010 were reported as the worst December figures since the monitor began in 1999. Once again aggressive discounting, clearance sales and promotions were widespread. The SRC noted 'Sales growth revived to its highest since July but this still represented a real terms fall once inflation is allowed for. The Christmas boost was well below both what Scottish retailers hoped for and the UK-wide figures. It came largely from a last-minute surge in the week before Christmas, helped by discounts and the shopping opportunity presented by the Saturday Christmas Eve' although profits warnings and cost cutting plans have been announced by a number of major retailers. More recent analysis by the Scottish retail Consortium suggest there was an 8.5% drop in foot fall (numbers shopping) in the three months to January.

Concerns were raised as to the impact of sales growth lower than inflation on cash management, stock control and on jobs and investment. Both commentators and industry bodies have noted that margins have been hit so hard that retail health is considered now to be in a worse state than at the depths of the 2008 recession and 2012 will be a difficult year for retailers. GVA Grimley (November 2011) noted that up to a sixth of retail spaces in some Scottish towns are now empty, notwithstanding reductions in rental charges. They noted that traditional town centres as being less able to withstand the effects of economic decline – compared to out of town centres (quoted in the Herald 24.11.2011). The annual shop vacancy report echoed these trends. The average national UK vacancy rate has risen from 3% in 2008 to 14.3% in 2011, with much higher levels in some Scottish towns reflecting a combination of insolvencies and national chains moving to out of town locations. There is much to suggest that vacancy rates will continue to rise, notwithstanding reductions in rental rates.

Conditions in the retail sector among SCBS firms did not improved during the crucial fourth quarter with declining consumer confidence and sales trends, increasing competition, rising costs and declining margins. Sales trends weakened further with more than 80% reporting, and more than three quarters expecting a decline in the total value of sales. Fewer than 10% of SCBS respondents reported or expect increased sales, as continuing concerns over consumer confidence remain evident. Cost pressures remain intense with transport costs and pay settlements being more of a concern. Pressures on margins remain widespread with over two thirds expecting declining profitability and turnover over the next year. Labour market activity continues to remain at historically low levels with no firms reporting or expecting to increase overall staff levels. The CBI's Distributive Trades survey (UK wide) for January

likewise noted retail sales down sharply on January 2011, with 44% reporting sales lower than in January 2011 and a net of 10% anticipating lower sales in February compared to February 2011. Continued pressures on family budgets and low confidence amongst consumers were seen to be the factors underpinning these results. The Scottish Retail consortium (January 2012 sales) reported, notwithstanding widespread discounting, the worst monthly figures for a decade, down 1.5% on last year, and like for like figures 2.6% lower than a year ago. Modestly rising food sales were offset by weaker non food sales.

Tourism

Business confidence declined further in Q4 for SCBS hotels and was significantly lower compared to Q4 2010 and to the lowest level since Q4 2008. The rising trend in total visitor numbers continued although weakened further and was better than had been anticipated.

PKF reported (November) declining room yields in Scottish hotels and only a modest rise in occupancy rates to 69.8% - but with marked differences between the major Scottish cities, with Aberdeen and Inverness both recording increases in occupancy and room yields, whereas both Glasgow and Edinburgh reported declining trends. In common with other surveys the PKF report noted rate cutting to sustain occupancy levels, and increased concerns for those currently running high debt levels. Whitbread whilst reporting 'stalling growth' in the UK hotel sector nevertheless reported increased like for like sales with its Premier Inn group reporting occupancy at 80.3%, well above the industry average. The rise of the budget hotel sector in recent years, with Premier Inn's capacity of over 40,000 rooms (and with a growth target of 4000 rooms and 13 restaurants in 2011) and Travelodge with over 32,000 rooms indicates the scale of change in the hotel sector and the increasing pressure on smaller and traditional hotels.

Average occupancy declined for SCBS hotels (from 75.4% to 56.8%) although was marginally better compared to the same quarter a year ago. The Scottish Guest House and B&B Occupancy Survey for November 2011 showed that both room and bed occupancy declined over the year. The Scottish Self-catering Occupancy Survey also reported a decline. The accountants PKF reported occupancy rates rose by 0.6% in Scotland compared to 1% in England. Their report noted that whilst room yields and occupancy declined in three and four star hotels in Glasgow and Edinburgh, Aberdeen hotels, possibly reflecting the more buoyant oil and gas sector, reported improved occupancy and yields.

During the three months to the end of December, trends in bar/restaurant trade and for conference/function facilities continued to decline among SCBS hotels. Half of hotels reported reducing average room rates and the widespread pattern of 'special offers' seems set to continue with more than half expecting to reduce room rates in Q1 2012. Three-quarters, compared to 84% in the previous quarter, reported that the lack of tourist demand remained the primary business constraint and almost a third noted competition. Poor transport infrastructure also remained a concern to hotels. 48% (compared to 56% in the third quarter) sought to recruit staff. Employment trends, as forecast declined in quarter four but the declines were not as steep as had been expected. A net balance of 201% expect a further decline in quarter one 2012.

Logistics and Wholesale

Data from the Scottish Chambers' Business Survey showed that the problems in the Scottish wholesale distribution sector continued. Business confidence amongst SCBS wholesale respondents eased marginally although again more than half of firms reported a decline in business confidence. Business confidence was once again considerably lower compared to one year ago. Firms in the third quarter survey had expected a decline in sales however the downward trend in sales trends eased in Q4. More than 90% of SCBS wholesalers reported increased pressures from transport costs. Cost pressures generally increased during the three months to the end of December and remained historically high. More than 70% expect to increase prices over the next three months, and cash flow trends remain weak. Once again concerns over turnover eased slightly however profitability remains low. Once again most firms reported no change to investment plans; nevertheless there appears to have been a marginal improvement. Wholesale respondents continued to shed staff during Q4 although the rate of decline eased further. Fewer than a third sought to recruit staff; largely for replacement.

Outlook

The slowing down of the weak recovery in the UK and eurozone economies, coupled with continuing consumer insecurity and reduced domestic spending, and with the impact of government spending cuts again dampened business confidence and activity. The pickup in activity in construction in Q2 2011 appeared short lived and continuing consumer uncertainty and reduced spending contributed to weaker results in retail and the closure of a number of retail groups. For a further quarter tourism benefited from some increase in the numbers of home visitors, but these have been sustained by widespread discounting. The corrosive effects of uncertainty both in Europe and at home coupled with weak consumer

confidence will combine to make 2012 a difficult year for Scotland.

At the end of 2011 the trends in demand and activity in construction were largely unchanged from a year ago, with widespread declining trends and pressures on margins being widely reported, once again the exceptional weather conditions are likely to impact on trends, especially in the first quarter given the need for repair and renewal following the winter storms. In tourism the outturn was weaker than anticipated and little changed from a year ago.

Structural changes continue to affect both the retail and tourism sectors and compound the difficulties in assessing the impact of the slowdown in economic activity on consumer spending. It is clear that the migration of retail outlets and consumers from traditional city and town high streets to out of town centres and internet based retailing is affecting retail activity, as is the widespread discounting and competition between the major supermarket groups. Equally the continued expansion of the number of budget hotel room numbers has contributed to more intense discounting of room rates in tourism. The impact of the Olympics on overall tourism numbers in the UK remains unclear, as is the impact on the Scottish tourism sector. However, there is much to suggest that weak consumer confidence and spending will continue at adversely affect these sectors through 2012.

Bank of Scotland PMI data for January reported a moderate improvement in business conditions, with rates of growth marginally faster than in the previous survey period. However, export orders weakened, albeit at the lowest rate for four months. The Scottish economy was seen as 'struggling to maintain growth momentum in the face of a global slowdown, but is, so far, avoiding a return to recession.' The Lloyds TSB English Regional PMIs noted that Scotland's growth in December was lower than all of the English regions, but unlike Wales and Nn. Ireland reported growth. In January Scottish growth was again better than Wales and Nn. Ireland, but again lower than all English regions except the South West.

There is much to suggest in the surveys that labour market activity remained limited with the majority of respondents not varying overall employment levels, nevertheless, SCBS respondents reported declining employment trends in all sectors and all sectors expect these weak employment trends to continue. Recruitment difficulties remained at low levels in all sectors. Pay increases in 2011 were at historically low levels and well below the rate of inflation, implying real declines in household income. In Q4 2011 pay increases amongst SCBS respondents ranged from 1.8% in manufacturing and construction, to 2.5% in retail and 3.5% in tourism, although were higher in the Scottish oil and gas sector.

Cliff Lockyer/Eleanor Malloy
February 2012

Current trends in Scottish Business are regularly reported by a number of business surveys. This report draws on:

1. Aberdeen & Grampian Chamber of Commerce Survey no 15 November 2011;
2. The Confederation of British Industries Scottish Industrial Trends Survey for the fourth quarter 2011;
3. Lloyds TSB Business Monitor for the quarter September 2011 – November 2011and expectations to May 2012;
4. Lloyds TSB Commercial, England Regional PMIs for January 2012;
5. Scottish Engineering's Quarterly Reviews for the fourth quarter of 2011;
6. The Bank of Scotland Markit Economics Regional Monthly Purchasing Managers' Indices for November, December 2011 and January 2012;
7. The Scottish Retail Consortium's KPMG Monthly Scottish Retail Sales Monitors October, November and December 2011 and January 2012;
8. The Scottish Chambers of Commerce Quarterly Business Survey report for the fourth quarter of 2011;
9. Oil & Gas UK quarterly Index Q3 2011;
10. Oil & Gas UK Economic Report 2011;
11. ONS Retail sales Q 4 2011;
12. Visit Scotland Occupancy Survey for October and November 2011;
13. The Scottish Construction Monitor October 2011;
14. 2012-2016 Construction Skills Network Scotland.
15. PKF Hotel Occupancy Report 2011

Overview of the labour market

Inevitably current interest in the Scottish labour market continues to focus on the levels and trends in employment and unemployment and again we return to these themes. In addition the UK Government has announced plans to 'radically reform employment relations' (Vince Cable 23.11.2011), in Scotland the proposals to introduce both a national police force and national fire service have been published. Attention also focussed on the rates of pay and bonuses in the financial sector to the neglect of pay relativities, other changes in pay, earnings and pensions for other groups, the subject of industrial action within the public sector at the end of 2011.

A radical reform of employment relations

In November the Government announced proposals, partially building on the Reducing Workplace Disputes and Effectiveness consultation conducted earlier in the year, and the announcement of a call for evidence as to the effectiveness of the current TUPE regulations, to reform employment relations. Most notably in terms of further deregulation to 'reduce the onerous and unnecessary demands on businesses', to reduce the impact of those measures which currently dissuade employers from hiring new staff, to reduce the costs to employers of the current employment tribunal system and to make some changes to existing dismissals procedures.

From April 2012 the qualifying period for unfair dismissal will be increased from one to two years. In addition changes to employment tribunal procedures are expected, these are likely to include measures which require all claims to initially be referred to the Arbitration and Conciliation Service before tribunal proceedings. There are proposals that employees would be required to pay a deposit to the tribunal before proceeding with a weak case is increased from £500 to £1000. There are changes to witness expenses which can result in the parties to the tribunal being directed to pay witness costs. Further proposed changes to tribunal procedures include an issue and listing fee, higher fees for those claiming more than £30,000, and a requirement for losing employers to reimburse fees. Further proposals include reducing the consultation period for large scale redundancies from 90 to possibly 60 or even 30 days, together with a revised definition of 'establishment'. For smaller firms (ten or fewer employees) a no fault dismissal procedure has been suggested.

The government has yet to issue a response to the consultation on proposed changes to family-related leave, flexible work and statutory holidays, although Cable's speech indicated an intention to proceed with the extension of the right to request flexible work to all employees, and to modernise new parents' rights. In addition there is to be a fundamental review of employment tribunal procedures and a consideration of proposals to reform workplace sickness and absence.

Whilst Dr Cable spoke highly of the German system of employee relations, noting employee participation on management boards, his proposals for reform did not extend to supporting the other principles of the German system of employment relations, namely worker participation or even the moves to the extent of work protection in the UK to the levels currently enjoyed in Germany. The proposed reforms were thought to be unworkable according to a survey of employment lawyers (Law Society Gazette 15th December 2011), other criticisms included the concern that the reforms could lead to a 'hire and fire' culture and would be of limited help to small businesses.

Pay levels, relativities and bonuses

Since 2008 the rate of increase in earnings has slowed significantly from 'an annual average of 4.2% in 2007, 3.9% in 2008, 1.7% in 2009 to 1.8% in 2010. In the year to June 2011 real earning fell by almost 3.8%, this follows a fall of 3.4% in the previous 12 months' (Lansley, TUC Touchstone Extras 2011). A review of pay settlements recorded by Incomes Data Services in the year to September 2011 noted that 98.8% of settlements were less than the RPI and some 63% were less than half the RPI inflations rate (Lansley, TUC Touchstone Extra). The CIPD Salary Survey covering January to June 2011 reported 77% of public sector, 55% of the voluntary sector and 52% of the private sector respondents reporting a pay freeze, and 4% of the public, 8% of the voluntary and 7% of the private sector respondents reporting pay cuts. The indications are that this pressure on real incomes will continue for several years. Lansley (2011) argues that the downward pressure on living standards is the result of five main factors: a continuing downward squeeze on pay rates, a worsening of working conditions, cuts in state spending and benefits and a 25% reduction in overtime hours. The latest CIPD survey data suggests some slight pick up in the percentage of private sector firms intending to increase pay, and at a slightly higher rate than that in the public sector.

In contrast, and the subject of much wider publicity, has been the pay and bonus increases for senior executives, most notably in sectors where there is an element of public ownership. As Incomes Data Services notes median total earnings for the lead executive in FTSE 100 companies has risen five times more quickly than those of the average employee between 2000 and 2011 (Lansley), and this gap has continued to widen. A contributory factor has been the introduction of performance related pay elements, these averaged 328% of salary amongst FTSE 100 in 2010 (High Pay Commission) The High Pay Commission's final report published in late 2011 noted the widening gap, amongst the

examples it gave included one bank which in 1979 top pay in was 14.5 times higher than the average employee it is now 75 times. The report notes (see table 1) the shift in income distribution in recent years, it argues, that if present trends continue, by 2035 the top 0.1% will take home 14% of national income – equivalent to the pattern in Victorian Britain. Already the top 0.1% share of national income is higher than most other countries, except the USA.

Table 1: National income distribution in the UK

Year	Top 0.1%	Top 1%	Top 10%
1979	1.3%	5.93%	28.4%
2007	6.5%	14.5%	40%

Source: High Pay Commission (2011) Final Report p22

The High Pay Commission only found evidence which challenged the link between pay and performance, they concluded:

- Salary growth over the past ten years bears no relation to market capitalisation, earnings per share or pre tax profit;
- There is little or no relation between total earnings trend and market capitalisation, salary growth;
- A slightly closer relation seems evident between total earnings, pre-tax profit and earnings per share, but they do not mirror each other exactly and the trend diverges significantly during certain periods.

The potential social consequences of increased inequalities in pay and earnings are fully discussed in the report. For those with longer memories there are parallels between the problems of payments by results (the performance and bonus schemes of the 1950s and 1960s) for manual workers with their wage inflationary consequences (see for example Research Paper No 11, Royal Commission on Trade Unions and Employers' Associations 1968), and the rise of performance based pay in the 1990s. There is much to suggest, that with a few exceptions the problem with performance management pay systems is that the meaningful is rarely measured and the measurable is rarely meaningful, and in the consequence of executive payments the pay is measurable but the performance improvement is not. There are few examples of pay back schemes or penalties for non achievement.

Notwithstanding the public concern as to executive pay rising youth unemployment has led to some criticisms that current minimum wage rates could be 'crowding out' young workers. At the Davos World Economic Forum debate one CEO (salary £900,000 and proposed 180% bonus) argued that the minimum wage legislation across Europe blocked young people from employment (As of October 2011 the minimum wage rates in UK are: £2.60 for year one apprentices; £3.68 for 16 – 17 year olds; £4.98 for 18 – 20 year olds and £6.08 for those aged 21 and over). More recently these ideas have resurfaced in the right wing of the Conservative party.

The Supplementary Regional Labour Market Statistics (December 2011) indicated the unemployment rate for 18 – 24 year olds was 23.5% for Scotland (October – December 2011), an increase of 5.9 percentage points over the year to October 2011, however, the report notes that in July – September 2011 of the 84,000 people aged 18 – 24 who were unemployed in Scotland, approximately 27,000 are also in full time education. About one in five unemployed young workers are those with low or no qualifications (NEETs), the hardest group to find employment.

Recent trends and statistics

Comparable figures on the labour market between Scotland and the United Kingdom in the quarter October - December 2011 are summarised in Table 2. Labour Force Survey (LFS) data show that in the quarter to December the level of employment in Scotland fell by 20 thousand, to 2,458 thousand. Over the year to December 2011, employment in Scotland fell by 28 thousand. For the same period, UK employment rose by 7 thousand. The Scottish employment rate (16 – 64) – those in employment as a percentage of the working age population – was 70.7 per cent, down 0.4 per cent compared to one year earlier. For the same period the UK employment rate was 70.3 per cent, down 0.2 per cent compared to one year earlier. Scottish unemployment, in the quarter to December, rose by 16 thousand to 231 thousand, a rise of 15 thousand over the year.

In considering employment, activity and unemployment rates it is important to remember the bases and relationships of these figures. LFS data (estimated) is provided for: (1) all aged 16 and over and (2) for all aged 59/64. The first measure (all aged 16 and over) leads to higher numbers in employment, in the total economically active and economically inactive – but reduces the economic activity rates and unemployment rates, but at the same time increases the economically inactive rate. Conversely the second measure (all aged 16 to 59/64) leads to lower numbers economically active, in employment and economically inactive – but leads to a higher economically active, employment and unemployment rates but lower economically inactive rates. Figures derived from the Labour Force Survey differ slightly from those derived from the Annual Population Survey.

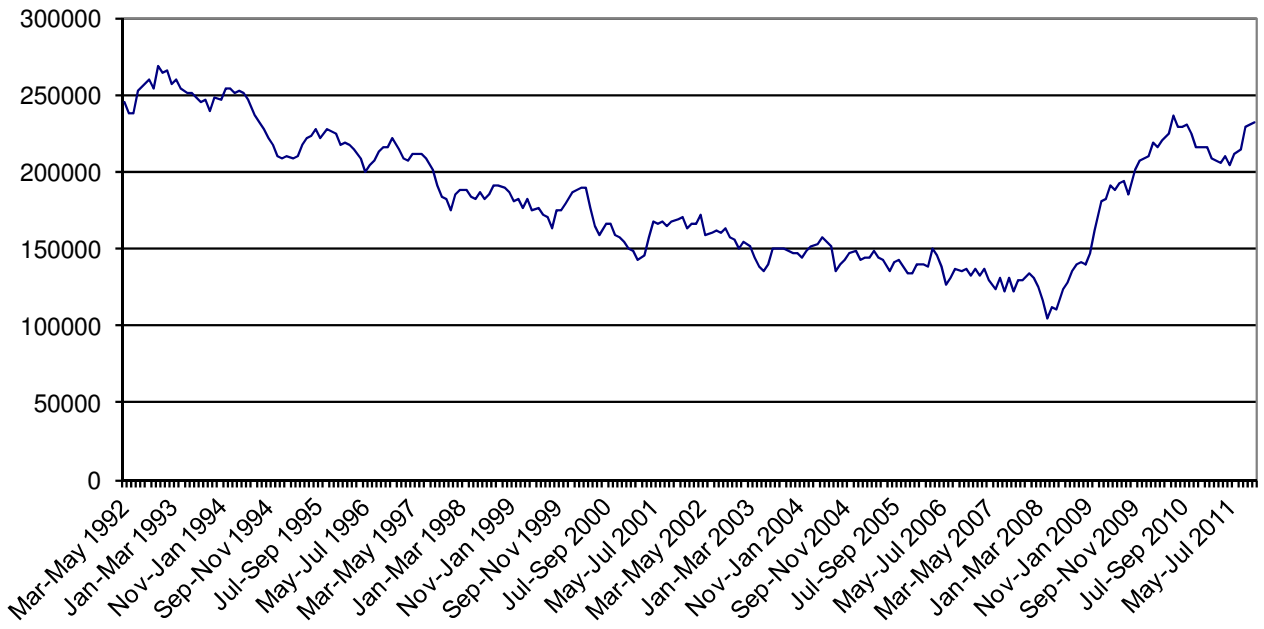
The relationships between employment, unemployment, totally economically active and inactive are important in appreciating changing levels of employment and unemployment, and changes in the employment rates should be seen in conjunction with changes in the activity rates. If people leave employment and become unemployed (but are still economically active) the unemployment rate increases, but the economically active rate remains unchanged. However, if people leave employment and do not seek employment, as seems to be a

continuing pattern, they are categorised as economically inactive, as such the unemployment rate remains unchanged whilst the activity and inactivity rates change. Equally the changing pattern between full and part time employment is of interest and we return to this issue later in this section. This is clearly shown in table 2. Over the year to December 2011, the numbers employed fell by 28 thousand, whilst unemployment rose by 15 thousand – and the numbers of those aged 16-59/64 who are economically inactive fell by 3 thousand and the numbers economically active rose by 4 thousand.

Table 2 shows that for Scotland the preferred International Labour Organisation (ILO) measure of unemployment rose to 231 thousand, between October – December 2011, a rise of 15 thousand over the year. The ILO unemployment rate rose in the three months to December 2011 and now stands at 8.6 per cent. This represents a 0.6 per cent rise over the last quarter and a 0.6 per cent rise relative to the same period a year earlier. The comparable ILO unemployment rate for the UK stands at 8.4 per cent, and is up 0.1 per cent over the most recent quarter and also up 0.5 per cent over the year.

Figure 1 illustrates the trend in unemployment in Scotland since 1992. Unemployment peaked in October – December 1992 at 268,000, it took almost five years - to August - October 1997 - to be consistently below 200,000 and a further five and a half years - to February – April 2003 - to be below 150,000 and reached the lowest number (111,000) in May – June 2008. If the same pattern is repeated, and unemployment does not rise in future months, then it may take approximately three years for unemployment to fall below 200,000.

Figure 1: Trend in Scottish unemployment 1992 – December 2011 (thousands)



Source: Labour Market Statistics (First Release), Scotland and UK, February 2012

The economically active workforce includes those individuals actively seeking employment and those currently in employment (i.e. self-employed, government employed, unpaid family workers and those on training programmes). Between October – December 2011 the numbers economically active (16+) fell 4 thousand and the activity rate fell by 0.2 to 62.9%. There were 2,689 thousand economically active people in Scotland during October - December 2011. This comprised 2,458 thousand in employment (2,406 thousand aged 16 – 64) and 231 thousand ILO unemployed. The level for those of working age but economically inactive fell by 2 thousand in the latest quarter, and fell by 3 thousand over the year thousand to 775 thousand people; this indicates a fall of 0.4 per cent in the number of people of working age economically inactive over the last year.

Data on employment by age, derived from the Annual Population Survey, is available up to June 2011. In the year to June 2011 employment rates fell for those aged 18 – 24 and those aged over 50, with the employment rate for those aged 16 – 64 falling by 0.1 percentage points and with the largest percentage point falls being recorded for those aged 50 - 64 (down 1.1%). Employment rates for women again

Table 2: Headline indicators of Scottish and UK labour market, Oct - December 2011 (thousands)

Oct - Dec 2011		Scotland	Change on quarter	Change on year	United Kingdom	Change on quarter	Change on year
Employment*	Level (000s)	2,458	-20	-28	29,129	60	7
	Rate (%)	70.7	-0.4	-0.4	70.3	0.1	-0.2
Unemployment**	Level (000s)	231	16	15	2,671	48	179
	Rate (%)	8.6	0.6	0.6	8.4	0.1	0.5
Inactivity***	Level (000s)	766	-2	-3	9,286	-78	-73
	Rate (%)	22.5	0.0	-0.1	23.1	-0.2	-0.2

Source: Labour Market Statistics (First Release), Scotland and UK, February 2012

* Levels are for those aged 16+, while rates are for those of working age (16-59/64)

** Levels and rates are for those aged 16+, rates are proportion of economically active.

*** Levels and rates for those of working age (16-59/64)

Table 3: Employment rates thousands (%) People by age for the four years July 2007 - Jun 2008 to Jul 2010 – Jun 2011

	All 16+	16 - 64	16 - 17	18 - 24	25 - 34	35 - 49	50 - 64	65+
Jul 2007 - Jun 2008	60.8	74.2	39.4	68.5	81.6	83.9	65.5	5.7
Jul 2008 - Jun 2009	59.8	72.8	38.0	65.9	80.3	82.3	64.8	6.6
Jul 2009 - Jun 2010	58.2	71.0	30.4	62.2	78.3	81.0	64.4	6.4
Jul 2010 - Jun 2011	58.0	70.9	33.6	61.2	79.0	81.6	63.3	6.6

Source: Labour Market Statistics (First Release), Scotland and UK, February 2012

fell more than those for men, except for those aged 50 – 64. Table 3 illustrates the changing employment rates by age group for the four years April - March 2008 – 2011 and illustrates consistent declines across all age groups, except 16 – 17 year olds.

In the year to December 2011 (the latest available data) inactivity amongst 16 – 64 fell by 3 thousand a 0.3% decrease over the year and the inactivity rate (16 – 64) stood at 22.5%. Inactivity for men aged 16 – 64 fell by 8 thousand (2.5%) over the last quarter and by 13 thousand (4.9% over the year). Inactivity for women was unchanged over the past quarter but fell by 600 over the year.

In the year to June 2011 inactivity fell by 1 thousand to 783 thousand. The main increases reported for the reasons for inactivity over the year were: retired up 9 thousand and long term sick up 9 thousand. The numbers looking after family and home rose by 3 thousand and those temporarily sick fell by 2 thousand. The majority 590 thousand did not want a job – but 193 thousand were inactive but wanted employment.

The most recent (seasonally adjusted) figure for Jobseekers allowance claimants (16+) in Scotland stood at 148.2 thousand in January 2012, up 2 thousand or 1.4% over the year (these figures are taken from table 8 in the Labour Market Statistics [First Release] February 2012. The claimant count rate at January 2012 stood at 5.3 per cent, or 6.8% for men and 3.5% for women (note these figures are taken from table 7 in the Labour Market Statistics [First Release] February 2012 figures and measures the number of claimants on the second Thursday of each month). The latest unemployment data at the Scottish constituency level is available in a SPICe Briefing.

Table 4 indicates the continuing significant differences in employment, unemployment and inactivity rates at the local authority level. However, between 2008 and 2009 the gap between the areas with the highest and lowest employment rates widened by 5.8 percentage points. In the year July 2010 – June 2011 employment rates varied from over 80% in Shetland to between 65 - 70% in ten local authority areas and below 65% in two local authority areas. Likewise unemployment rates were again lowest in Aberdeenshire, Orkney and Shetland and highest, 11.8%, in North Ayrshire.

Table 4: Employment, unemployment and inactivity rates by Local Authority Area 2007, 2008 and July 2010 – June 2011 (%)

	Employment rates			Unemployment rates 16+*			Economic inactivity rates		
Geography (Residence Based)	2007	2008	Jul 2010/ Jun 2011	2007	2008	Jul 2010/ Jun 2011	2007	2008	Jul 2010/ Jun 2011
Scotland	76.0	75.6	70.9	4.7	4.9	7.8	20.1	20.3	23.0
Local Authority Area									
Aberdeen City	79.1	79.4	75.4	3.7	3.6	5.3	17.3	17.6	19.6
Aberdeenshire	82.6	82.2	79.7	2.5	2.6	4.0	15.6	15.5	16.4
Angus	79.1	80.0	72.3	4.5	4.6	7.1	16.2	15.6	21.1
Argyll & Bute	80.0	77.6	73.9	4.0	4.3	6.2	16.3	18.4	21.4
Clackmannanshire	69.4	70.9	72.5	5.5	5.4	8.6	25.3	25.4	22.5
Dumfries and Galloway	77.4	76.2	69.6	4.2	4.5	6.8	19.1	19.5	24.5
Dundee City	72.1	71.5	71.7	6.6	6.3	8.6	22.4	23.9	22.3
East Ayrshire	73.1	74.6	68.5	6.3	6.1	9.9	21.5	20.4	24.2
East Dunbartonshire	78.9	77.6	71.7	3.1	3.9	5.9	19.0	18.7	23.7
East Lothian	79.2	77.9	71.5	3.5	3.5	7.1	18.0	19.4	22.6
East Renfrewshire	77.2	76.5	72.2	3.4	3.6	5.6	19.1	20.5	22.6
Edinburgh, City of	77.4	76.6	72.1	4.3	4.5	6.3	19.5	19.8	23.2
Eilean Siar	79.4	78.7	65.9	4.2	4.6	6.8	17.7	16.3	31.1
Falkirk	78.1	78.9	72.9	4.6	4.4	8.0	18.5	18.3	21.2
Fife	75.9	76.5	71.7	5.6	5.8	9.0	18.8	17.7	20.5
Glasgow City	66.9	66.6	62.1	6.8	6.9	11.3	28.2	28.8	29.2
Highland	82.0	81.7	78.0	3.2	3.5	5.1	16.0	16.3	18.6
Inverclyde	68.4	72.5	70.3	7.1	6.4	9.0	24.8	23.0	22.9
Midlothian	80.7	79.9	72.9	4.2	4.2	7.7	15.1	16.2	20.5
Moray	80.4	81.8	78.7	3.5	3.8	4.9	17.2	15.0	18.8
North Ayrshire	71.5	71.8	62.8	6.4	7.4	11.8	23.5	22.0	28.2
North Lanarkshire	73.2	71.0	68.8	5.4	5.9	10.3	22.6	23.8	22.9
Orkney Islands	86.4	83.9	78.6	2.7	2.9	4.0	11.2	14.2	17.8
Perth and Kinross	78.1	78.7	75.6	3.5	3.7	5.0	18.8	17.9	20.7
Renfrewshire	75.0	76.0	66.6	5.1	5.5	9.5	20.9	18.9	26.0
Scottish Borders	81.4	80.6	73.7	3.1	3.6	5.7	16.2	15.8	22.2
Shetland Islands	88.1	88.0	85.1	2.6	2.8	3.5	10.4	10.8	13.8
South Ayrshire	77.2	75.4	67.1	5.0	5.4	8.9	18.9	20.5	25.5
South Lanarkshire	78.9	76.7	71.5	4.2	4.4	7.6	18.5	20.6	24.4
Stirling	76.8	75.2	69.3	3.9	4.5	7.1	19.2	20.2	24.6
West Dunbartonshire	73.9	71.2	68.6	6.3	6.9	10.8	20.8	23.3	22.8
West Lothian	77.8	79.1	72.7	4.8	4.6	7.6	17.7	17.4	21.9

Source: 2007 and 2008 data from Annual Population Survey (Jan to Dec)
July 2010 – June 2011data from Labour Market Statistics (First Release), Scotland and UK, February 2012 (Source Annual Population survey, Job Centre Plus administrative system and Annual Business Inquiry)

Notes: See sources for definitions and original sources

and 11.3% in Glasgow, and inactivity rates were highest in Eilean Star and Glasgow City

The most recent figures for the number of workforce jobs by industrial activity are detailed in Table 5. Total workforce job figures are a measure of jobs rather than people. Total seasonally adjusted workforcee jobs for the quarter ending September 2011 (the latest available figures) stood at 2,611 thousand 2,272 thousand employee jobs, 323 thousand self employed jobs, HM forces and supported trainees 16 thousand) although it is necessary to note significant recent revisions to the 2009 and 2010 figures noted in the November 2011 Commentary. Table 5 provides some indication of both the impact of the recession and the recovery on sectors, although the trends need to be considered with some caution. Over the year to September 2011 the most significant job losses have occurred in agriculture (11.2%), construction (15.2%), transport and storage (15.9%) and accommodation & food service activities (17.8%), in contrast the declines in the service sector have been more modest – finance & insurance (5.9%), public admin etc (-4.4%) and education (3.4%).

Table 5: Total workforce jobs* by industry, Scotland, June 2005–2011 and Sept 2011 (thousands)

Industry	June 2005	June 2006	June 2007	June 2008	June 2009	June 2010	June 2011	Sept 2011
A : Agriculture, forestry and fishing	51	54	60	60	59	62	55	53
B : Mining and quarrying	25	28	30	30	29	27	29	30
C : Manufacturing	233	226	228	212	201	181	176	172
D : Electricity, gas, steam and air conditioning supply	10	10	13	16	19	19	20	19
E : Water supply; sewerage, waste management etc	16	18	17	16	14	14	15	14
F : Construction	181	194	203	199	185	188	172	165
G : Wholesale & retail trade; repair of motor vehicles etc	382	384	380	396	398	363	389	397
H : Transportation and storage	125	118	123	123	111	140	113	117
I : Accommodation and food service activities	189	190	188	191	186	197	180	175
J : Information and communication	72	73	79	69	68	75	67	69
K : Financial and insurance activities	114	107	91	98	100	95	96	93
L : Real estate activities	25	29	30	32	32	23	29	32
M : Professional, scientific and technical activities	145	154	161	176	174	157	174	187
N : Administrative and support service activities	174	180	192	200	185	176	172	181
O : Public administration & defence; social security	180	177	181	177	146	145	139	138
P : Education	199	200	192	208	208	197	210	201
Q : Human health and social work activities	384	399	383	398	401	375	431	431
R : Arts, entertainment and recreation	75	81	75	84	71	72	71	71
S : Other service activities	63	65	63	58	59	67	65	65
Column Total	2,644	2,685	2,690	2,740	2,651	2,571	2600	2611

Source: Labour Market Statistics (First Release), Scotland, February 2012

* Workforce jobs are a measure of jobs rather than people

Note: There have been considerable revisions to the June 2009 and June 2010 from previous figures and as of September 2011 ONS are highlighting figures with a coefficient of variation greater than 25%

Table 6 outlines the changing patterns of full time and part time employment, and highlights the growth in the numbers of part time workers in Scotland, the latest data (July 2010 – June 2011), indicates that since the peak in employment (October 2007 – September 2008) total employment (employees, self employed, unpaid family workers and those on government supported training and employment programmes) has fallen by 81 thousand. Table 6 indicates the numbers of full time workers in Scotland since the peak in employment have declined by 122 thousand whilst part time employment numbers recovered very quickly and are now 40 thousand higher. The changing trends in full and part time employment since October 2007 – September 2008 are shown in figure 2. The number of self employed is now 3 thousand above that reported in October 2007 – September 2008, suggesting some substitution of self employment for employment. The number of those working part time because they could not find a full time job is 51 thousand higher than the peak in employment, suggesting that increasing numbers of workers were taking part time employment in the absence of full time work (the same argument applies to temporary work). Interestingly, and once again a comparison of tables 3 in the first release for Scotland and for the UK figures suggests that, in relative terms, the decline in full time employment has been greater in Scotland than in the UK, but in contrast the growth in part time employment, in relative terms, has been greater suggesting that the relative 'better' performance in employment in Scotland in recent quarters has been fuelled by a growth in part time employment, as a comparison of FTEs would suggest. The relative growth in the numbers of self employed has been greater in the UK than in Scotland.

Figure 2 illustrates that full time employment is still 3.66 percentage points below the level before the recession, whilst part time employment is 6.44 percentage points higher than that recorded before the recession. It clearly shows how the employment 'recovery' has been driven more by an increase in part time employment.

Table 7, drawing on the Annual Population Survey, attempts to explore how the pattern of jobs has changed since the onset of the recession, it suggests a growth in the numbers employed in personal service, sales and customer service and elementary occupations, and some decline in managerial, professional (but a slight rise in associate professional and technical occupations), and process, plant and machine operatives. The spate of recent mergers in the professional services sector reflects the downturn in activity and suggests further losses in these sectors. This pattern would resonate with trend in increasing numbers of part time employees, but raises some concerns as to the potential availability of sufficient skills to sustain a recovery.

Table 6: Trends in total, full, part time, temporary and part time who could not find a full time job

	All in employment							
Scotland	Total[1]	Employ-ees[1]	Self employed[1]	Full-time workers[2]	Part-time workers[2]	Workers with second jobs	Temp-orary employees	Could not find full time job
Jan 2007 - Dec 2007	2,525	2,244	263	1,892	631	93	128	60
Apr 2007 - Mar 2008	2,533	2,248	267	1,900	630	96	126	60
Jul 2007 - Jun 2008	2,544	2,254	271	1,912	629	98	125	61
Oct 2007 - Sep 2008	2,550	2,262	269	1,916	631	98	119	61
Jan 2008 - Dec 2008	2,529	2,243	268	1,900	626	99	116	64
Apr 2008 - Mar 2009	2,527	2,245	267	1,899	624	101	117	65
Jul 2008 - Jun 2009	2,515	2,235	264	1,880	632	103	123	73
Oct 2008 - Sep 2009	2,503	2,220	265	1,856	644	102	127	81
Jan 2009 - Dec 2009	2,492	2,211	265	1,844	645	102	133	84
Apr 2009 - Mar 2010	2,470	2,185	267	1,815	652	101	132	90
Jul 2009 - Jun 2010	2,462	2,179	265	1,802	656	99	126	96
Oct 2009 - Sep 2010	2,466	2,183	264	1,798	663	98	127	99
Jan 2010 - Dec 2010	2,469	2,181	268	1,793	671	97	124	106
Apr 2010 - Mar 2011	2,471	2,182	270	1,796	670	97	125	110
Jul 2010 – Jun 2011	2,469	2,179	274	1,794	671	95	131	113

Source: Labour Market Statistics (First Release), Scotland, February 2012

Note: 1. Includes people who did not state whether they worked part time or full time

2. The split between full time and part time employment is based on respondents' self classification

Figure 2: Trends in full time and part time employment since October 2007 – September 2008 (October 2007 – September 2008 = 100)

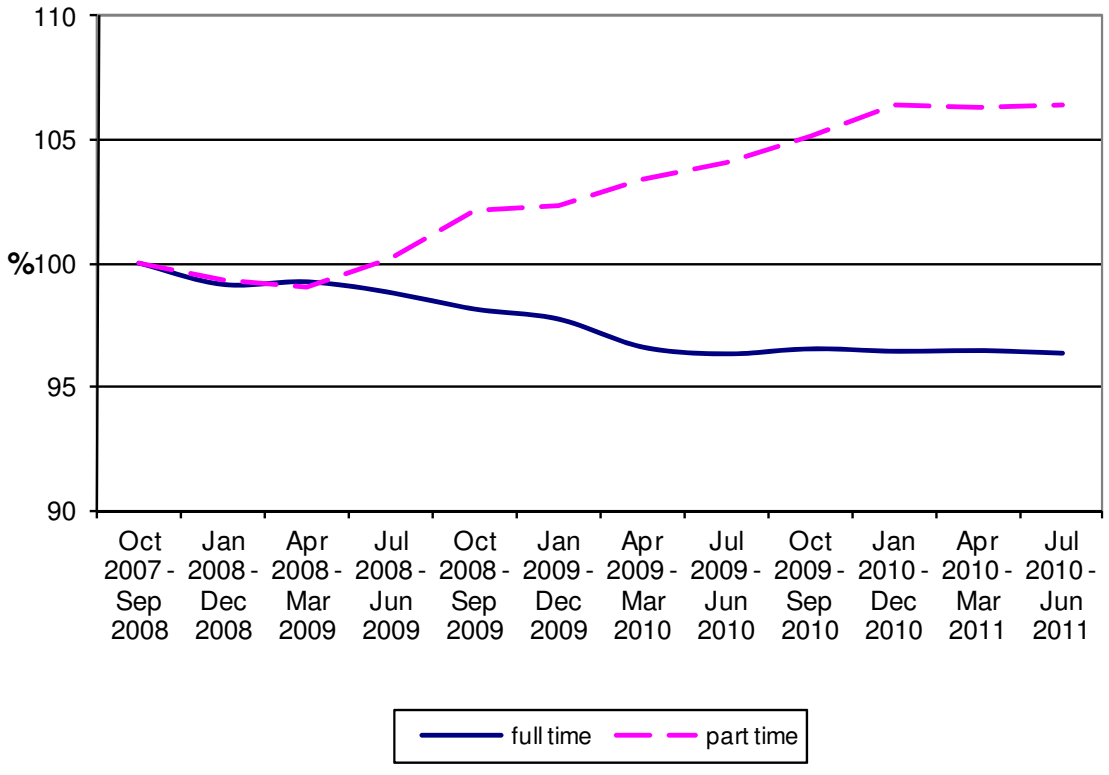


Table 7: Trends in employment by Standard Occupational Classification

	Jul 07 Jun08 percent	Jul 08 Jun 09 percent	Jul 09 J un 10 percent	Jul 10 - Jun 11 percent	Jul 10 - Jun 11 number
Managers and senior officials	13.0	13.5	13.3	13.1	323,800
Professional occupations	12.9	13.4	12.7	13.3	329,300
Associate Prof & Tech occupations	14.7	14.7	14.7	15.1	372,300
Administrative and secretarial occupations	11.4	11.3	11.3	10.6	260,700
Skilled trades occupations	11.5	11.4	11.3	11.0	272,000
Personal service occupations	9.1	8.8	9.3	9.6	235,900
Sales and customer service occupations	8.1	8.0	8.4	8.5	210,600
Process, plant and machine operatives	7.3	7.2	6.8	6.8	167,500
Elementary occupations	11.6	11.6	11.9	11.8	290,300

Source: Labour Force Survey

Tables 7 and 8 of the Labour Market statistics (first release) provide information of the claimant count. The figure forJanuary indicates a total of 148.2 thousand claimants, up 12 thousand for the year. Of interest are the differing trends in the claimant count for men and women. The claimant count for men, 104.3 thousand was down 1.9 thousand over the year, whereas the comparable figure for women, 43.9 thousand, was 3.9 thousand higher than a year ago.

Table 8 provides some limited indications of the experience of unemployment in terms of claimant count by age and duration. The latest figures suggest that 29.6 thousand have been claiming benefit for more than a year, up 8,900 over the year and 7.4 thousand have been claiming for more than 2 years, up 2.6 thousand over the year.

Trends in public sector employment are now considered in more detail a separate section in the Commentary. As the section indicates public sector employment in Scotland continues to decline. The latest data (Q3 2011) indicates that there were 588,900 employed in the public sector in Scotland, a decrease of 23,500 (3.8%) since Q3 2010. Employment in the devolved public sector declined by 21,200 (4.1%) to 492,000, due mainly to a decline in local government employment (down 13,300 over the year). Public sector employment (headcount and excluding public sector financial institutions) is now at its lowest since Q4 2001 and in percentage terms the lowest in the current data set (1999 - 2011).

Table 8: Total claimant count and computerised claims by age and duration (Numbers and percentage change over year to January 2012)

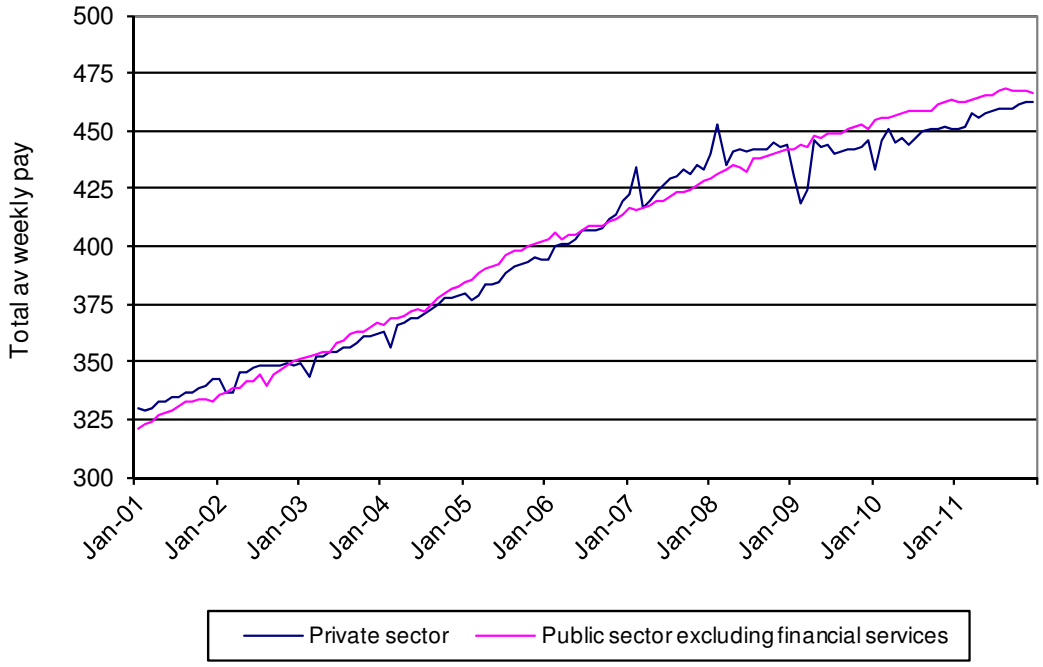
	All computerised claims	All computerised claims Up to 6 months	All computerised claims Over 6 and up to 12 months	All computerised claims All over 12 months
All 16+ numbers	147,800	86,900	31,300	29,600
All 16+ % change over year	1.9%	-11.7	21.1	42.7
All 18 – 24	42,300	28,600	9,500	4,200
All 25- 49	81,100	45,900	17,200	23,500
All 50 and above	23,400	12,400	4,600	6,400

Source: Labour Market Statistics (First Release), Scotland, February 2012

More significantly the current freeze on public sector pay with a cap of 1% on the average pay increase for 2013 – 2014 (announced in the Chancellor's autumn statement) together with proposals to link public sector pay to local labour markets coupled with the current increase pension contributions and proposals to change pension arrangements led to widespread industrial action towards the end of 2011, and is likely to contribute to further industrial action.

In the longer term the changing relationship between public and private sector pay will be increasingly significant, already there are some indications that specialist public sector staff are reacting to the current pay freeze by moving to the private sector. Previous eras of pay restraint in the public sector which have reduced earnings relative to the private sector have led to subsequent 'high' increases and/or to periods of industrial action

Figure 3: Total weekly earnings UK private and public sector 2001 – 2011



Source: Labour Market Statistics (First Release), Scotland, February 2012

Outlook

Over the past year total employment declined by 28,000 and unemployment rose by 15,000. The declines in public sector employment were not offset by rising private sector employment. All the indications are that unemployment will continue to rise through 2012. As we have noted in previous Commentaries any recovery in employment is likely to be slow and limited. Reducing unemployment/increasing activity rates for areas with a history of higher levels of unemployment will be particularly difficult and harder than in the past given the changing landscape of local and central government services.

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February 2012

Public Sector employment in Scotland

Some 300,000 public sector workers in Scotland participated in the UK wide public sector strike at the end of November 2011, in response to plans to change pension arrangements, pension links to the CPI, retirement age and contributions. The Government announced a revised arrangement, broadly, although not universally accepted, on 20th December.

Public sector employment in Scotland continues to decline. The latest data (Q3 2011) indicates that there were 588,900 (546,000 excluding public sector financial institutions) employed in the public sector in Scotland, a decrease of 23,500 (3.8%) since Q3 2010. Employment in the devolved public sector declined by 21,200 (4.1%) to 492,000, due mainly to a decline in local government employment (down 13,300 over the year). Public sector employment (headcount and excluding public sector financial institutions) is now at its lowest since Q4 2001 and in percentage terms the lowest in the current data set (1999 - 2011).

As Table 1 and Figure 1 indicate public sector employment (excluding public sector financial institutions) rose between 1999 and 2006, but since 2007 has declined by 42,600. Although the movement of local authority staff both in and out of arms length organizations, typically charities, makes comparisons slightly harder.

Local Government

Table 2 indicates the changes in headcount by local authority and indicates a both decline in Local Authority employment of 13,300 (4.5%) over the year, and some evidence of acceleration in the rate of reduction in employment. Attempts to rely on voluntary measures and natural wastage may prove to be lower than expected, as normally turnover rates ease during a recession, there will be more pressure on other methods to reduce employment levels. Pressures on spending levels will lead to employment reductions. Evidence as to changes in organization and employment policies in Local Government in England suggests a number of approaches to reducing labour costs that may well be adopted in Scotland (Work in Progress (December 2011), The Audit Commission. December 2011). These included:

- The potential for localising pay rates to reflect local market conditions;
- Increased emphasis on part time working – especially for those approaching retirement;
- Less spending on external expert services;
- Reduced use of agency staffs;
- De-layering with an emphasis on cutting more heavily management and senior posts (but recognising the potential loss of organizational memory on efficiency);
- The outsourcing services at reduced costs to voluntary and other associations as well as to commercial organizations;
- The ending of automatic annual pay increments.

The policies of contracting out local government services to the voluntary sector have meant that cuts in local government expenditure have impacted on the voluntary sector. As Cunningham (2011) notes the voluntary sector had been subject to a number of cost pressures in the New Labour Era, leading to job insecurity and pressure on terms of employment, and voluntary organisations were increasingly unable to match public sector salary scales. The current era of public sector cuts increases the pressure on voluntary sector organisations to reduce costs, Cunningham notes that already some local authorities have imposed cuts on providers ranging between 4% and 20%. The report noted that 36% of organisations surveyed had seen a decrease in their annual turnover over the past three years; over half had reported no cost of living increases in their contracts (68%) or their grants (98%). As a consequence pay freezes have been widespread, there have been some wage cuts, but more generally organisations were seeking to reduce wage costs by reducing training, deskilling, cuts to terms and conditions and reduced hours of work.

Education

Changes to the terms and conditions of supply teachers (supply staff have to work for five days at the lowest daily rate of £78 for five consecutive days in the same school before pay rises to the normal rate of £145), designed to save some £60 million lead to councils experiencing considerable problems In meeting both short and long term supply cover. A study Scottish Labour found that 84% of local authorities could not meet all requests for short term cover in 2011/2012 and 52% experienced difficulties in filling long term requests. Inevitably this will lead to further numbers of teachers in non permanent posts considering whether or not to remain in the sector.

Within the education sector the numbers employed in Scottish Further education colleges had declined by 2,000 (11.8%) over the year to Q3 2011 to 15,100) and further reductions are inevitable. The publication of the Scottish Government's Reform of Post 16 Education and subsequent consultation paper outlined the Government's proposals for a very rapid restructuring of 35 colleges into 12 regions with a programme of mergers, collaboration, sharing services and courses. Four different structures for the regional model were outlined in the consultation paper: full mergers, regional federations of colleges, lead colleges with

Table 1: Number of people employed in Scotland (headcount)

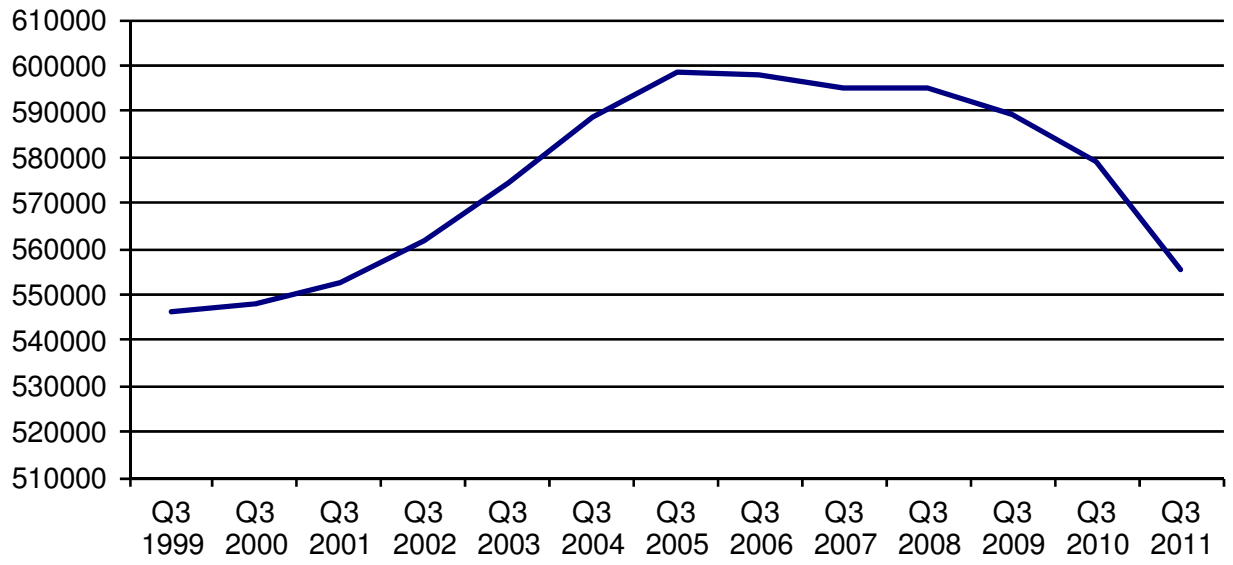
	Total Employment	Private Sector		Public Sector		Public Sector *Excluding public sector financial institutions*	
	Level	Level	%	Level	%	Level	%
Q3 1999	2,293,000	1,746,600	76.2%	546,000	23.8%	546,000	23.8%
Q3 2000	2,355,000	1,807,000	76.7%	548,200	23.3%	548,200	23.3%
Q3 2001	2,345,000	1,792,800	76.4%	552,700	23.6%	552,700	23.6%
Q3 2002	2,352,000	1,790,500	76.1%	562,000	23.9%	562,000	23.9%
Q3 2003	2,408,000	1,833,400	76.2%	574,100	23.8%	574,100	23.8%
Q3 2004	2,441,000	1,852,200	75.9%	588,600	24.1%	588,600	24.1%
Q3 2005	2,456,000	1,857,300	75.6%	598,500	24.4%	598,500	24.4%
Q3 2006	2,499,000	1,901,300	76.1%	597,800	23.9%	597,800	23.9%
Q3 2007	2,552,000	1,956,800	76.7%	595,300	23.3%	595,300	23.3%
Q3 2008	2,552,000	1,957,000	76.7%	594,900	23.3%	594,900	23.3%
Q3 2009	2,507,000	1,878,700	74.9%	628,100	25.1%	589,400	23.5%
Q3 2010	2,479,000	1,866,500	75.3%	612,400	24.7%	578,800	23.3%
Q3 2011	2,486,000	1,896,800	76.3%	588,900	23.7%	555,200	22.3%

Source: Quarterly Public Sector Employment series, Scottish Government, Office for National Statistics

Notes:

1. Figures have been rounded to the nearest hundred. Total employment has been rounded to the nearest thousand.
2. Public sector financial institutions include Northern Rock (classified to the public sector from Q4 2007), Royal Bank of Scotland Group plc and Lloyds Banking Group plc (both classified to the public sector from Q4 2008).
3. Between Q3 2010 and Q2 2011 estimates for the civil service include temporary field staff recruited to carry out the 2011 census.

Figure 1: Number of people employed in the public sector in Scotland (headcount) excluding public sector financial institutions



Source: Quarterly Public Sector Employment series, Scottish Government, Office for National Statistics

Local Government

Table 2: Local Government employment by local authority (headcount) Q3 207 – Q3 2011 (Not seasonally adjusted)

Year Quarter Local Authority / Joint Board	2007 Q3	2008 Q3	2009 Q3	2010 Q3	2011 Q3	Annual Change Headcount	Annual Change %
Aberdeen City	11,600	11,500	9,400	8,900	8,800	-100	-0.7%
Aberdeenshire	13,600	13,800	14,600	14,500	13,900	-600	-4.3%
Angus	5,700	5,800	5,700	5,600	5,500	-200	-2.9%
Argyll & Bute	5,300	5,300	5,400	5,200	4,800	-400	-7.9%
Clackmannanshire	2,900	2,900	2,800	2,800	2,600	-200	-7.6%
Dumfries & Galloway	8,300	8,200	8,300	8,200	7,800	-400	-4.6%
Dundee City	8,300	8,300	8,100	8,000	7,300	-800	-9.5%
East Ayrshire	6,900	6,800	6,700	6,600	6,500	-100	-1.6%
East Dunbartonshire	4,800	4,900	5,000	4,900	4,300	-500	-10.5%
East Lothian	5,000	4,900	5,000	4,800	4,700	-100	-2.9%
East Renfrewshire	4,800	4,800	4,800	4,600	4,500	-100	-2.2%
Edinburgh, City of	20,500	20,100	19,000	18,500	17,800	-700	-4.0%
Eilean Siar	2,600	2,600	2,600	2,500	2,500	0	-1.6%
Falkirk	7,900	8,000	8,100	7,900	7,400	-500	-6.8%
Fife	22,500	22,500	22,800	22,400	21,100	-1,300	-5.7%
Glasgow City	33,500	31,800	23,300	22,300	21,600	-800	-3.4%
Highland	12,600	12,700	12,800	12,700	12,100	-600	-4.9%
Inverclyde	5,200	4,800	4,800	4,600	4,400	-200	-4.3%
Midlothian	4,600	4,700	4,700	4,800	4,600	-200	-3.9%
Moray	4,900	5,100	5,200	5,100	4,900	-100	-2.9%
North Ayrshire	7,500	7,500	7,300	7,100	6,800	-400	-5.1%
North Lanarkshire	18,000	17,900	18,200	17,200	16,300	-900	-5.2%
Orkney Islands	2,200	2,400	2,400	2,400	2,300	-100	-3.2%
Perth & Kinross	6,000	6,100	6,100	6,000	5,900	-100	-2.0%
Renfrewshire	9,100	8,800	8,600	8,300	7,500	-900	-10.4%
Scottish Borders	5,800	5,800	5,700	5,700	5,600	-100	-1.7%
Shetland Islands	3,700	3,800	4,100	4,200	4,000	-200	-5.2%
South Ayrshire	5,700	5,700	5,600	5,600	5,300	-300	-5.1%
South Lanarkshire	16,000	15,800	15,900	15,500	15,100	-400	-2.6%
Stirling	4,500	4,400	4,400	4,500	4,100	-300	-7.3%
West Dunbartonshire	6,200	6,300	6,600	6,100	6,100	-100	-1.3%
West Lothian	8,300	8,400	8,500	8,400	7,800	-500	-6.4%
Total Fire Joint Boards	5,700	5,800	5,800	5,700	5,600	-100	-1.5%
Total Police Joint Boards	23,600	23,800	24,700	24,700	23,900	-900	-3.5%
Total Valuation Joint Boards	700	700	700	600	600	0	-3.7%
Total Regional Transport Partnerships (SPT)	700	700	700	700	600	0	-4.6%
SCOTLAND	315,200	313,200	304,500	297,700	284,500	-13,300	-4.5%

Source: Joint Staffing Watch Survey, Scottish Government

Notes: 1. Figures are rounded to the nearest hundred.
2. Totals may not add up to the sum of the parts due to rounding
3. Figures for fire service staff exclude volunteer and retained fire-fighters
4. There are minor adjustments to police numbers for Dumfries and Galloway and Fife
5. Figures for Dundee City and Falkirk reflect some transfer of staff to charitable trusts

contractual arrangements with other colleges and collaboration where each college is funded directly but with collaboration required. In January colleges were invited to apply for a share of £15 million to help pay for redundancy schemes to deliver staffing changes (mergers and other efficiency gains). Given the numbers that have already left the sector via voluntary agreements compulsory redundancies seem more likely.

Reform continued in the Higher education sector. The publication in January of the 'Review of Higher Education Governance in Scotland' reflected some concerns as to the trend for some universities to be controlled by small groups of officials' rather traditional bodies. Its main recommendations included: new legislation to set out the principles of governance of Scottish universities and a definition of academic freedom; a code of governance to be drafted by the Scottish Funding Council; changes to the membership, functions and public access to university courts and, somewhat topically, the abolition of bonuses for principals and other changes to the bodies that award pay to university principals. Further, and possibly more significant, initiatives from the Scottish Government are likely this year.

Glasgow University's experience of restructuring from nine academic faculties to four colleges in one year was recognised as being 'over ambitious', more so given new course developments, major IT developments and staff reductions, should be a lesson for other public agencies planning major organizational change.

Emergency Services

Elsewhere the pace of reform of the public sector continues to accelerate with the publication of proposals for a single Scottish police force and a similar national organisation for the emergency services, with the interim headquarters of the national police force being based at the Scottish Police College at Tulliallan and the new Scottish Fire and Rescue Service based at Perth Community Fire Station. The speed of the reforms, the proposed date for the start of the new police force being April 2013, has raised concerns both as to the costs of the integration and the inevitable dislocation to services, and the loss of organizational knowledge and experience that rationalisation will bring, and the potential losses to local areas as functions such as purchasing are centralised. Newspaper reports have indicated that up to 2,000 police support jobs could be lost, in addition to reductions in previous years. In recent years there has been a policy of the civilianisation of police forces Police staff (civilian staff) constitute approximately 28% of total staff and can be found in three main roles: corporate (27%), administrative and support (61%) and Operational (12%) (Stewart 2009:8). It is unclear from the current proposals the extent to which savings in operational support staff (for example crime prevention, custody & detention and scenes of crime officers together with force intelligence analysts) can be achieved by the rationalisation.

The reform of the police service is seen as essential to protect and improve frontline services for local communities against the backdrop of severe budget restrictions, 'by stopping duplication of support services eight times over and not cutting the provision of front line services' (Business and Regulatory Impact Assessment – Police and Fire & Rescue Services Reform). In addition the reform is justified in delivering more equal access the specialist support and national capacity and 'to strengthen the connection between services and communities at each of the 32 local authorities; involving many more local councillors and better integrating with community planning partnerships' (Business and Regulatory Impact Assessment – Police and Fire & Rescue Services Reform).

The background to the Police and Fire Reform (Scotland) Bill and the current concerns are well summarised in a SPICe Briefing published 20th February 2012. Notwithstanding the issues of loss of organizational knowledge through the rationalisation process there are a number of governance issues, both in terms of the new Police Authority (appointment and membership) and independence. In operational terms concerns exist as to the role and powers of the local police commanders and their relationship to local authorities. It may well be that the current geographical divisional structures adopted by the current police forces will be the basis for the new local structures, with these being subject to less change and rationalisation than the current head quarters divisions. However, balancing local and national priorities will be problematic and the bill does not prescribe how local authorities should implement arrangements for scrutiny of local policing.

Financial issues of the proposed reforms have been discussed in the Police Reform Programme, Outline Business Case September 2011 and more recently the issues have been summarised in a SPICe Briefing (20th February 2012) Financial Scrutiny Unit Briefing Police and Fire Reform (Scotland) Bill: Financial Memorandum. BRIA estimates that a national model will deliver by year 5 gross recurrent efficiency savings of around £151 million, although in practice this figure would be reduced (Police Reform Programme, Outline Business Case, September 2011).The Business Case assumes a natural wastage rate of 3% and significant redundancy costs over the first five years peaking in year 4 at almost £34 million (see table A5 page 87). Potential savings are outlined in Table A1 with almost a third of the savings coming from the rationalisation of support functions, and further savings through management de-layering, rationalised span of control and consolidation of resources. It remains unclear as to whether or not these savings can be reduced given the previous achievements in savings through rationalisation, or whether more extensive reductions in staff numbers will be sought.

Developments in England give some indications as to the areas where the new national police force may seek to reduce staffing costs in addition to reducing the numbers of police officers and police staff. In January the home secretary accepted a set of proposals designed to reduce police staffing costs in England, these included, in addition to the changes affecting most public sector employees (a pay freeze and increased pension contributions), a two year freeze on officers automatically moving up pay scales and the abolition of special priority payments. Potentially more significant will be contained in the second part of the current review which will consider the current pay negotiating arrangements basic pay, career length and pensions. Interestingly the Police Arbitration Tribunal did not accept the recommendation to reduce the rate of payment for overtime working, nor a reduction to accept a lower on-call allowance.

The Chancellor's autumn statement indicated the introduction of a 1% cap on public sector pay following two years of a pay freeze and the potential 3% increase in employee pension contributions. Already public sector workers have, as a consequence of inflation, experienced a cut in real earnings of nearly 8%. But, continued pay restraint and increased pension contributions have lead a number of unions to suggest that this will mean cuts of up to 15% in real terms for public sector employees by 2014/5.

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February 2012

Economic perspectives

Has there been an economic dividend from devolution?[1]

Jo Armstrong, Richard Harris, John McLaren and John Moffat

1. Introduction

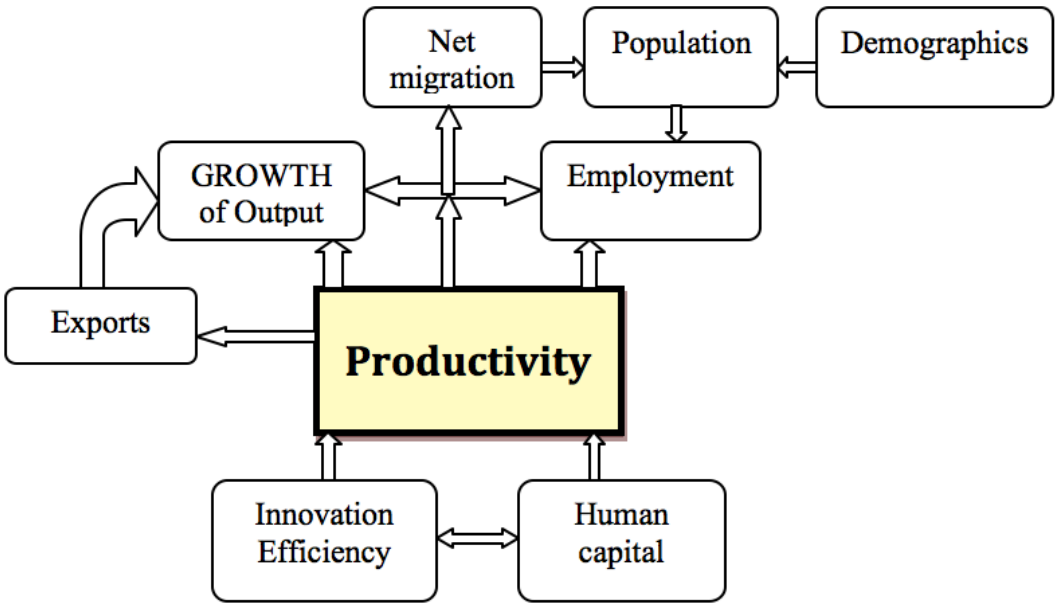
It is now over twelve years since the restoration of Scotland's parliament, after a hiatus of almost three centuries. Sufficient time has therefore elapsed that it is possible to provide some evidence on whether Scotland's economy has indeed performed better under devolution. Thus we look at productivity, GVA per head, employment, and R&D to see if there has been any relative improvement post-1999. Having done this, two of the channels through which devolution may affect these variables will be discussed: the composition of expenditure and policy innovation[2]. This is particularly timely given that the UK and Scottish parliaments are currently considering proposals which will give further fiscal powers to the Scottish parliament, and the Scottish government is planning to hold a referendum on full independence in the autumn of 2014.

2. What happened?

In considering Scotland's post-devolution, there is a need to consider what is most likely to bring long-run (sustainable) economic growth to the nation. According to Krugman (1997), in the determination of living standards, 'productivity isn't everything but in the long run, it is almost everything'. Similarly, Baumol (1984) states that 'it can be said without exaggeration that in the long run probably nothing is as important for economic welfare as the rate of productivity growth'. Figure 1 shows our emphasis on the central role of productivity in determining living standards and identifies innovation and efficiency alongside human capital as the determinants of productivity.

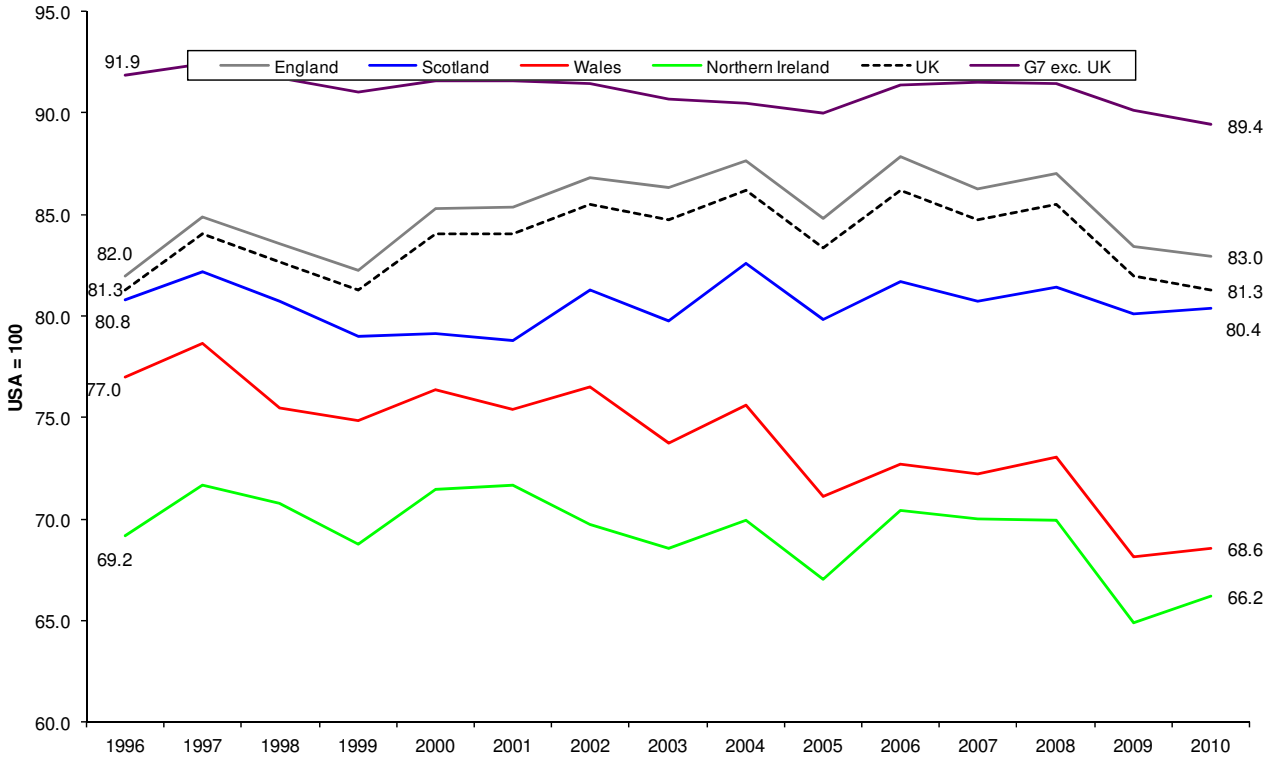
Figure 2 shows workplace productivity, measured as GDP per hour worked, in the different nations of the UK (and the G7 excluding the UK) relative to productivity in the US since 1996. Scotland's productivity in 2010 was 80.4% of the US level. This is down slightly from a figure of 80.8% of the US level in 1996. Throughout the period, Scotland's productivity has been higher than in Northern Ireland and Wales (notably the Welsh position has deteriorated over time) but lower than in England. There is no obvious *positive* step-change in productivity performance in the devolved nations since 1999.

Figure 1: Drivers of growth



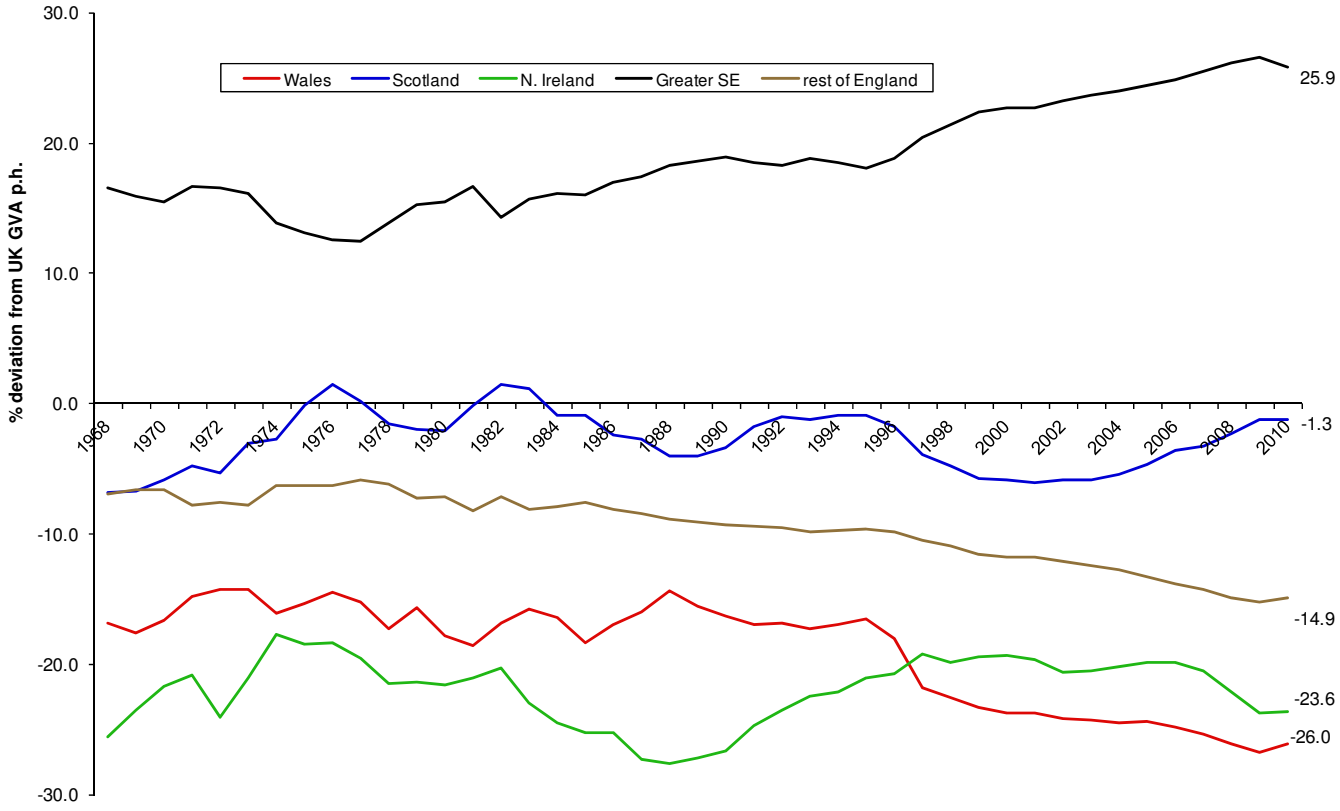
Source: CPPR (2008)

Figure 2: GDP per hour worked, UK and G7 countries relative to USA, 1996-2010



Source: ONS Labour Productivity

Figure 3: Relative (headline) GVA per head, UK regions, 1968-2010



Source: Calculations based on ONS Regional Accounts

Turning to a wider measure of economic well-being, Figure 3 shows relative GVA per head of population, relative to the UK average, for the four nations of the UK (with England divided into the Greater South East[3] and the rest of England). Scotland has been close to the UK average since 1968. During that period, the Greater South East has improved its GVA per head significantly while the rest of England and Wales has seen significant relative falls in their GVA per head. Since 1999, Scotland has managed to raise its GVA per head, relative to the UK average, so it has now almost reached parity with the UK average. However, as Figure 3 shows, there is still a large gap between Scotland and the Greater South East, although improvement has been seen relative to the rest of England, Wales and Northern Ireland.

Following the approach of Harris and Trainor (1999), whether there has been any greater convergence or divergence post-devolution can be tested econometrically using the following equation:

$$\Delta(y_{SC} - y_C)_t = \varphi(y_{SC} - y_C)_{t-1} + \mu + \gamma_1 t + \gamma_2 t * dev_t + \varepsilon_t \quad (1)$$

where y_{SC} and y_C are GVA per capita in Scotland and a comparator, respectively; μ is an intercept; t is a time trend; and dev_t *is* a dummy variable that takes the value of one from 2002 onwards (i.e. the period post-devolution)[4]. The dependent variable is therefore measuring the change in the gap between GDP per capita for Scotland and a comparator region (3 different comparators are used below). The parameter $\gamma 1$ measures whether the gap between Scotland and the comparator region is trending upwards or downwards over time[5] and γ_2 indicates whether this trend (if it exists) has accelerated or decelerated since devolution.

Reflecting what is seen in Figure 3, Table 1 shows that when the comparator used is the UK (either excluding the Greater SE or just excluding the Continental Shelf), there is evidence of a small, but significant, acceleration in the rate of convergence since devolution (when the latter is measured post-2001)[6]. When the comparator is Greater SE, the devolution time trend is not significantly different from zero. However, the inability to reject the null (H0: φ) that the lag of the gap in GVA per capita between Scotland and the comparator region is not different from zero suggests that there is no equilibrium relationship between the two series (so the above results regarding the devolution trend need to be interpreted with caution)[7].

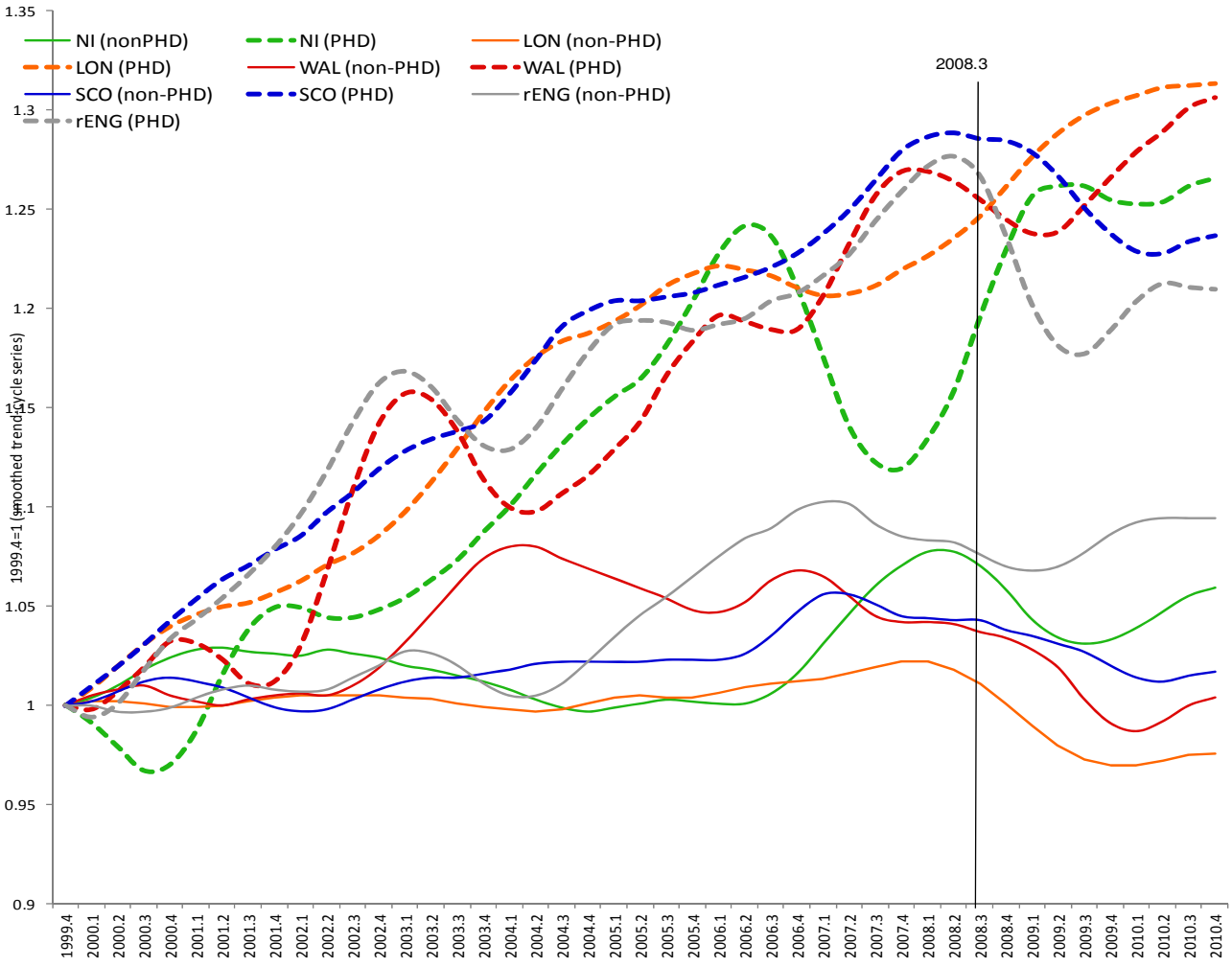
A further measure of Scotland's absolute and relative improvement in welfare/growth is the level of employment.

Table 1: Estimated parameters from model of convergence

Comparator:	UK excluding Greater South East	UK excluding Continental Shelf	Greater South East
Constant	0.0119**	0.0048	-0.0058
	(0.0047)	(0.0045)	(0.0140)
(Scotland GVA – Comparator GVA)t-1	-0.1551	-0.1131	-0.1079
	(0.0851)	(0.0718)	(0.0780)
Trendt	-0.0000	-0.0004**	-0.0009***
	(0.0002)	(0.0002)	(0.0003)
Devolutiont × Trend	0.0003**	0.0003**	0.0003
	(0.0001)	(0.0002)	(0.0003)
No. of Observations	42	42	42

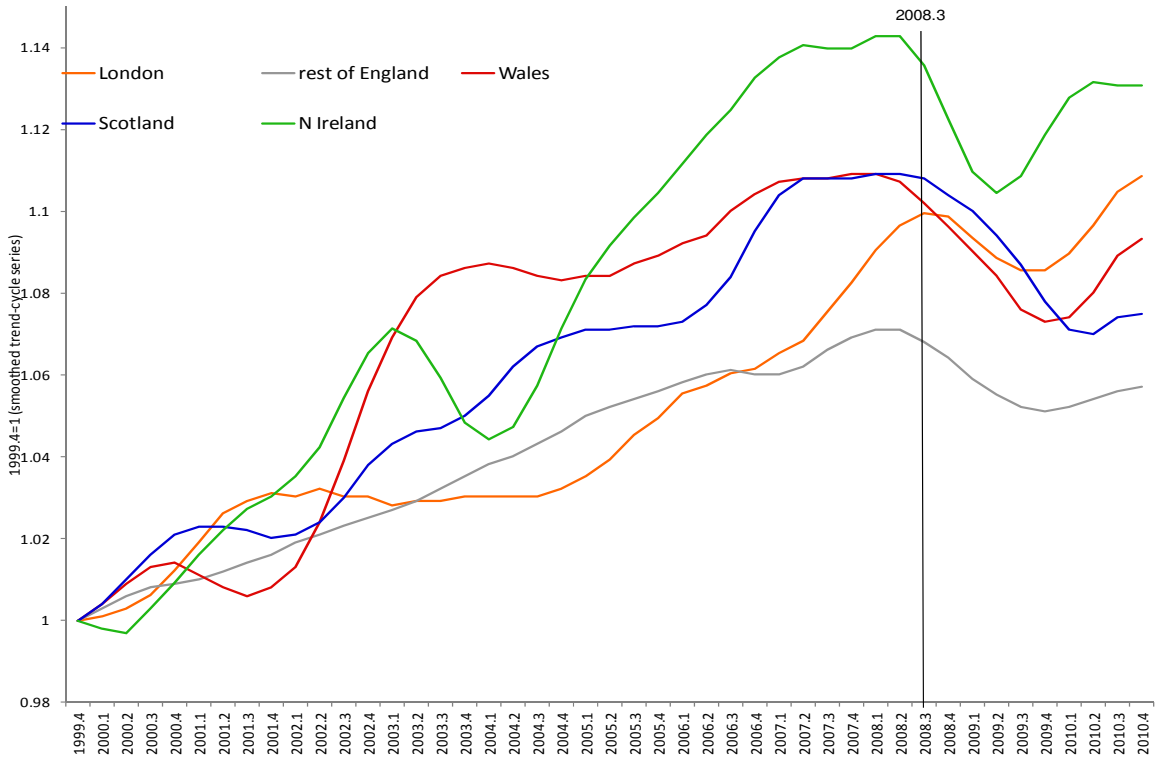
Note: Standard errors in parenthesis. **/*** significant at 5/1% level based on standard t-test.

Figure 4: Employment levels (1999q4=1), employed and self-employed, 1999-2010



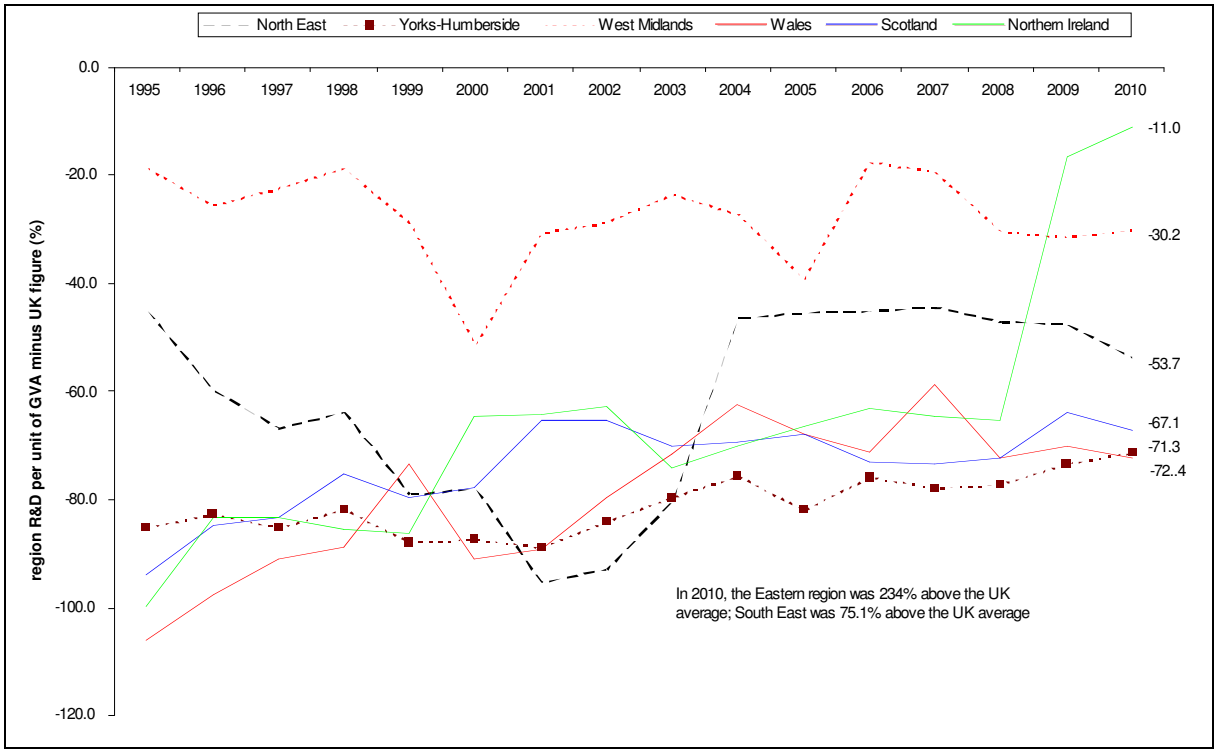
Source: Labour Force Survey

Figure 5: UK Employment levels (1999q4=1), employed and self-employed, 1999-2010 (Public administration, defence, health and education - PHD - sector versus non-PHD sector)



Source: Labour Force Survey

Figure 6: R&D spending per unit of GVA relative to UK figure, 1995-2010



Source: Business Enterprise R&D and Regional Accounts

Figure 4 shows the trend in employment across the different nations of the UK (with England split into London and the rest of England) since the last quarter of 1999. All nations have higher employment than at the beginning of the period with Northern Ireland achieving the most remarkable rise in employment. Scotland also performed relatively well until 2009. However, the rebound in employment after the recession has been far smaller in Scotland than in other parts of the UK which means that, over the period as a whole, Scotland has only performed better than the rest of England.

Figure 5 shows that, when the employment figures in Figure 4 are disaggregated into two broad sectors (public administration, defence, health and education – labelled PHD from now on – versus all other industries)[8], then, in all parts of the UK, most of the rise in employment is attributable to the PHD sector. In Scotland, Wales and London, aggregate employment growth would have been non-existent or negative, had this sector not expanded. This is clearly a worrying finding given that such employment growth in the PHD sector is more likely to be stagnant or negative in the near future, because of the current UK government's commitment to cuts in public expenditure.

Figure 6 shows R&D expenditure per unit of GVA relative to the UK average for selected UK regions[9]. This is important as R&D is a key determinant of productivity (see, e.g. Harris & Moffat, 2011). Among the selected regions, Scotland's R&D performance has improved slightly since 1995 but has remained relatively poor. Of the selected regions, only Yorkshire & Humberside and Wales had lower R&D expenditure per unit of GVA in 2010. To the extent that R&D is a leading indicator of future performance, this is a worrying finding. Note: these R&D figures are based on information covering the most important R&D spending firms in the UK; thus they are likely to underestimate R&D spending by smaller firms. Table 2 presents nationally representative data from a different source, showing Scotland (and to a lesser extent Wales) to have the smallest proportion of firms innovating and/or conducting R&D[10].

One argument for devolution is that it allows budgets to be spent in accordance with local preferences (cf. the literature on fiscal federalism, especially Tiebout, 1956; Oates, 1972). One way of testing this hypothesis is to look at whether there have been changes in the composition of expenditure since devolution. This can be done with data from the ONS Public Expenditure Statistical Analyses and using the following model:

$$spending_{it} = \alpha_0 + \sum_{d=1}^{3} \alpha_i dev_{it}^{d} + \beta time_t + \sum_{d=1}^{3} \delta dev_{it}^{d} \times time_t + \varepsilon_{it} \quad (2)$$

where $spending_{it}$ measures the proportion of expenditure going to a given area of expenditure in region *i* at time *t,* dev_{it}^{d} is a dummy variable that takes the value of one from 1999 onwards in devolved region *d*; $time_t$ is a time trend that shows how expenditure has grown in the non-devolved regions of the UK (i.e. the regions of England). The coefficient on $dev_{it}^{d} \times time_t$ is of greatest interest as it shows whether the percentage point increase (decrease) in expenditure has been faster (slower) in devolved region *d* and therefore provides a measure of the degree of policy heterogeneity[11].

However, it must be acknowledged, that this method will not necessarily capture policy heterogeneity because differences in policy do not necessarily require changes in expenditure (the same amount can be spent, but spent on a different 'mix' of underlying services captured by the aggregate figures). Furthermore, given that a large proportion of spending is on wages, which will increase or decrease at the same rate across the UK, looking for variation in expenditure totals may be a very strict test of policy heterogeneity.

The results from estimating equation (2) by OLS regression[12], for those areas in which the majority of expenditure is under the control of the Scottish government, are given in Table 3. Taking health as an example, the coefficients can be interpreted as follows (taking each in turn): at the start of the period, on average 18.3% of identifiable expenditure went towards health across the English regions; there was no significant difference in the amount of identifiable expenditure going towards health in Scotland at the start of the period; health expenditure in England has growth by 0.4 percentage points per year since 1999; health expenditure in Scotland has grown by 0.1 percentage points less (i.e. 0.3 percentage points) than in England over the period. This latter we can take as evidence of policy heterogeneity in Scotland.

It is reasonable to expect that expenditure on enterprise and economic development, agriculture, forestry and fisheries, transport and education and training will have the most direct impact on economic performance (through potential increases in productivity). Expenditure on education and training, and transport, has been growing by 0.1 fewer percentage points, and by 0.2 more percentage points, respectively, in Scotland compared to England. The difference is positive but not statistically significant in enterprise and economic development and agriculture, forestry and fisheries. In sum, therefore, there is no clear indication of expenditure moving towards those areas that are likely to improve the performance of the Scottish economy in the future

However, there has been little evidence of such economic policy innovation. Most recent economic policy documents (see Northern Ireland Executive, 2011; Scottish Government, 2007; Welsh Assembly Government, 2010) from the devolved nations focus on the same drivers of growth such as R&D, training and investment and employ the same type of methods to encourage them (based on comparable analysis undertaken at HM Treasury after 1997.

In doing so, they tend to follow the UK strategy documents (HM Treasury, 2000, 2001)

Another argument for devolution is that it encourages policy innovation by creating inter-jurisdictional competition. However, there has been little evidence of such *economic* policy innovation. Most recent economic policy documents (see Northern Ireland Executive, 2011; Scottish Government, 2007; Welsh Assembly Government, 2010) from the devolved nations focus on the same drivers of growth such as R&D, training and investment and employ the same type of methods to encourage them (based on

Table 2: Percentage of establishments producing a product innovation or undertaking R&D, 2002-2008

	Product innovation	Blue-sky innovation[a]	R&D
South East	25.9	13.0	33.3
Eastern England	25.8	12.3	32.3
East Midlands	25.5	11.5	31.0
South West	24.9	11.2	30.0
West Midlands	24.1	10.9	30.6
UK	24.0	11.1	30.8
Yorks-Humberside	23.4	10.4	30.2
North East	23.3	10.4	29.4
London	23.1	11.0	30.9
Wales	23.0	10.3	29.4
North West	23.0	9.8	30.1
Scotland	20.8	9.2	28.3

[a] Introduction of a new product that is new to the industry (not just the firm)

Source: weighted data from Community Innovation Surveys, 2002-2008

Table 3: Estimates of parameters from Equation (2), 1998-2010

Dependent variable - % of identifiable expenditure going to:	General Public Services	Public Order & Safety	Enterprise & Economic Development	Agriculture, Fisheries & Forestry	Transport	Housing & Community Amenities	Health	Recreation, Culture & Religion	Education & Training
Constant	0.015***	0.061***	0.015***	0.020***	0.033***	0.012***	0.183***	0.020***	0.160***
	(0.000)	(0.002)	(0.001)	(0.001)	(0.002)	(0.001)	(0.001)	(0.000)	(0.001)
Devolution × Scotland	0.008***	-0.011	0.005	-0.001	-0.005	0.019***	0.001	0.005***	0.001
	(0.001)	(0.007)	(0.004)	(0.004)	(0.007)	(0.005)	(0.005)	(0.002)	(0.004)
Devolution × Wales	0.006***	-0.007	0.017***	-0.005	-0.002	-0.001	-0.009**	0.007***	-0.010**
	(0.001)	(0.007)	(0.004)	(0.004)	(0.007)	(0.005)	(0.005)	(0.002)	(0.004)
Devolution × NI	0.008***	0.048***	0.015***	0.013***	-0.014*	0.029***	-0.030***	-0.006***	0.006
	(0.001)	(0.007)	(0.004)	(0.004)	(0.007)	(0.005)	(0.005)	(0.002)	(0.004)
Time Trend	0.000	0.000	-0.000	-0.001***	0.000*	0.001***	0.004***	-0.001***	0.001***
	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)
Time Trend × Devolution × Scotland	-0.000	-0.000	0.000	0.001	0.002**	-0.001	-0.001**	0.000	-0.001**
	(0.000)	(0.001)	(0.001)	(0.001)	(0.001)	(0.001)	(0.001)	(0.000)	(0.001)
Time Trend × Devolution × Wales	0.001***	-0.000	-0.000	0.001	0.000	-0.000	-0.001	0.000	-0.001
	(0.000)	(0.001)	(0.001)	(0.001)	(0.001)	(0.001)	(0.001)	(0.000)	(0.001)
Time Trend × Devolution × NI	0.000	-0.003***	-0.001**	0.000	0.001	0.001	-0.000	0.001***	-0.003***
	(0.000)	(0.001)	(0.001)	(0.001)	(0.001)	(0.001)	(0.001)	(0.000)	(0.001)
Observations	156	156	156	156	156	156	156	156	156

Note: standard errors in parenthesis.

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comparable analysis undertaken at HM Treasury after 1997. In doing so, they tend to follow the UK strategy documents (HM Treasury, 2000, 2001).

3. Conclusion

Our review of economic indicators has failed to provide any strong evidence of a significant impact – following the (re)-creation of the Scottish parliament – on Scotland's relative economic performance. While there has been some post devolution impact in terms of improved GVA per head relative to the UK, as shown in Figure 3 and Table 1, the remainder of the evidence fails to highlight why this might have occurred. For Wales and Northern Ireland there is even less to suggest devolution has resulted in any economic dividend.

However, it ought to be acknowledged that our approach can be criticised on the grounds that it may be unsuitable for identifying a causal impact of devolution. A better approach, particularly in relation to productivity, would be one to estimate the impact of devolution at a micro-level, as that would allow us to control for many of the determinants of firm productivity (see, for example, the approach used by Harris and Moffat, 2011). The detailed work needed to undertake this approach is something we plan to do in the near future.

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Endnotes

[1] This paper is based on the presentation the Urban and Regional Economic Study Group on 11th January, 2012. We wish to thank the participants for comments, with the usual disclaimer that only we are responsible for the final views expressed here.

[2] Identifying a causal impact of devolution on different indicators of economic performance is difficult. This is because of the problems inherent in estimating what would have happened to Scotland's economy, had the Scottish parliament not been created (the counterfactual). As a result, in this paper, we generally rely on comparisons of Scotland's performance with that of other regions and with its performance prior to devolution. Both have shortcomings as measures of what would have happened in the absence of a Scottish parliament because of differences in others factors across time, and across regions, that will affect performance.

[3] Specifically, London, the South East and the East of England.

[4] We started with dev_t having the value of one from 1999 onwards, but the results were not significant for Scotland. However, as any policy changes will take time to fed through to changed outputs, then using a later start date for the dummy seems reasonable.

[5] A negative (positive) sign indicates that the gap is getting larger (smaller).

[6] Results (not shown here) for Wales and Northern Ireland never show any evidence of convergence or divergence, even when (to give devolution a fairer chance of working) we have experimented by setting dev_t to later years.

[7] Note, the t-values obtained from the analysis must be compared to the Dickey-Fuller distribution, and not the Student's *t*-distribution.

[8] Note, the first broad sector (public administration, defence, health and education) mostly comprises employment in the public sector (some 77% of total employment in 2010.q3 was in the public sector based on data from the ONS series "Public Sector Employment

Statistics"). Thus overall, most jobs depend directly on public sector spending.

[9]R&D spending in Northern Ireland rose significantly in 2009-2010. Part of the reason seems to be a significant increase in spending by the aerospace industry in the Province.

[10]Similar data for is available for Northern Ireland (but was not available here).

[11]It may be thought unlikely that any significant policy heterogeneity will emerge immediately after the creation of the devolved bodies. To allow for a delayed impact of devolution, we experimented by changing the definition of dev_{it}^{d} to being a dummy variable that takes the value of one from 2000, 2001 and so on onwards in devolved region *d*. Using 2000 to 2003, there was little impact on the results for Scotland but using 2004 onwards a larger number of the coefficients on the $dev_{it}^{d} \times time_{t}$ became statistically significant although their magnitude remained small. This implies that it took a lengthy period of time for the Scottish Parliament to begin to deviate from UK spending priorities.

[12]This method is not strictly applicable in the current situation because the dependent variable is bounded between 0 and 1. However, it has the advantage of providing results that are easy to interpret.

Should housing benefit be devolved to Scotland[1]

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University of Glasgow

Introduction

In the on-going debates about additional financial powers for the Scottish Parliament, fiscal autonomy and indeed the independence referendum and the 'devolution max' alternative, giving Scotland powers over all or some aspects of social security is, for many, a Rubicon-crossing decision; a point of no return. However UK Government's welfare benefit reforms in general and the cuts to Housing Benefit in particular have given this issue urgency. The Holyrood Committee examining the Scotland Bill and debates in the chamber have questioned the absence of Scottish powers in areas, such as housing, where a reserved policy (such as Housing Benefit) limits the ability of the Scottish Parliament to determine the outcome of devolved policy areas (such as housing). In the election campaign, the SNP manifesto said that the party would seek the devolution of Housing Benefit.

In this exploratory paper, we look at the prospects for devolving Housing Benefit within the existing settlement (i.e. with the rest of social security reserved) and also in terms of a devolution max variant wherein the rest of the social security system is also devolved. However, in order to fully grasp the possibilities and challenges facing such policy reform, it is important to first set out how the Housing Benefit system works and interacts with both income maintenance and housing policies. This reveals important structural problems with the present system, ones that will remain unresolved by the reforms and cuts presently underway.

The context for devolving benefit

The current system

Housing Benefit is nested within and essential to the present working of means-tested benefits within the reserved UK system of social security. Eligibility is limited to tenants, but extends to both those who are in or out of work (subject to a means-test).

It fulfils two essential functions:

- income maintenance: Housing Benefit is designed to protect incomes after rents to ensure that households can purchase sufficient other necessities;
- affordability: Housing Benefit limits the burden of housing costs to some households so that they do not absorb a disproportionate amount of the household budget.

It is this ambiguity between the housing policy objectives and those of income maintenance that sets the UK system apart from its continental counterparts and is at the heart of many of its difficulties. The income maintenance objective became more explicit in the system introduced in 1988. It explains why (in principle) Housing Benefit can pay the whole of someone's rent and why (in principle) a rent increase in its entirety can be met by it.

Such policy dualism also helps to explain why it has been difficult to reform (Stephens, 2005). The UK housing lobby has often been drawn to other European housing allowance models where, to simplify, less generous targeted allowances have operated alongside more generous systems of social security and pensions (see: Kemp, editor, 2007). The UK is unique in making no allowance for housing costs within its mainstream social security benefits.

Looking at the system's details, eligible council tenants receive *rent rebates*, which are operated as deductions from their rents. They are directly applied to the individual rent statements of tenants by the council, which also administers the system. An assumption is made in the financial settlement for the Scottish Parliament each year relating to average rent increases and their consequent impact on the Rent Rebate bill, which is an explicit part of the Parliament's public spending block. Eligible housing association tenants receive a *rent allowance*, which, for virtually all intents, is the same system from the point of view of tenants, though it is not controlled fiscally in the same way and has no direct implications for the Scottish Block. Private tenants are, however, treated differently through the *Local Housing Allowance* system (see below).

The general position for a social (council or housing association) tenant in terms of eligibility is that, provided their rent is less than or equal to their eligible housing cost ceiling, they will have *all* of their rent met by Housing Benefit if their assessed weekly income is less than or equal to the their assessed need for their household circumstances (the applicable amount of the income support scheme, modified for Housing Benefit purposes – e.g. employing assumptions about the levels of savings allowed). Should their income rise above the assessed need threshold, there is a 65 pence reduction in Housing Benefit for every pound that income exceeds the applicable amount (until it falls to zero).

Housing Benefit thus prevents eligible rents from taking incomes below social assistance (e.g. JSA, IS, Pension Credit) levels and this implies that rising rents will be fully met provided they remain within eligible housing cost limits.

At the same time, rising rents will draw more households into eligibility. This is reinforced by the practice of the great majority of housing association landlords receiving Housing Benefit directly from the administrating local authority rather than via the tenant. This practice of 'Rent Direct' ensures rent/benefit payments reach the landlord and helps to reduce the incidence of arrears but it also further disconnects the tenant from the responsibility for meeting their housing costs.

There are further complexities. Eligible recipients receive 'earnings disregards' that do not count as assessed income in order to encourage work. Second, adult children or other non-dependents living in a larger household are assumed to make a contribution to the rent. Thus eligible rent is reduced through 'non-dependent deductions', so reducing Housing Benefit. Third, the system discourages young people (aged under 26) from living independently by setting a Housing Benefit ceiling (the 'single room rent') as if they lived in bedsit accommodation with shared facilities.

Eligible private tenants receive the Local Housing Allowance. LHA sets standard eligible rents at the median market rent for broad market rental areas for different sizes of properties. In principle, where an eligible private tenant received that allowance, and if rents are less than the allowance, the claimant could keep part of the difference (up to £15) – thereby rewarding shopping around for value. But if the actual rent comes out above the median, the tenant would have to pay the difference. If a tenant's circumstances and hence income changes, this will be reflected in eligible Housing Benefit in the same way as with social tenants. The other key feature of the Local Housing Allowance is that apart from those tenants deemed to be vulnerable and those already in arrears, the benefit takes the form of a cheque or bank transfer to tenants – there are no direct payments to landlords.

The scale of housing benefit

Measured in cash terms, GB Housing Benefit was £11.65 billion in 2000-2001 and rose to £17.50 billion in 2008-09. The estimated outturn figure for 2009-10 was £20.44 billion and the planned figure for 2010-11 was in excess of £22 billion (Pawson and Wilcox, 2010, Table 114). This increase in cost and the threat of further increases explains the priority that government benefit cuts focused on Housing Benefit immediately after the formation of the Coalition.

The caseload evidence suggests a significant fall in rent rebate cases (from 2.1 million in 2001 to 1.5 million in 2010 for GB) compared with a near doubling in rent allowances (from 1.7 million to 3.2 million across the same period - Pawson and Wilcox, 2010, Table 115a). Further disaggregation of the rent allowance data between housing associations and private rented housing confirms large caseload growth for both (not quite doubling between 2001 and 2010) with the association caseload still slightly larger. The reduction in the number of rent rebate recipients and increase in housing association recipients reflects the transfer of council stock to associations.

This shift also occurred in Scotland, where the rent rebate caseload fell from 214,000 in 2001 to 151,000 in 2010, whereas rent allowances increased from 92,000 to 186,000 in the same period (Pawson and Wilcox, 2010, Tables 115b and 115c). The Scottish Government (2011) also report (pp.10-11) that the largest single group receiving HB are the over 65s (which is otherwise flatly distributed by age). Nearly 2 in 3 recipients are single people without dependents but almost one in five are single parent households. Only 6% are couples with dependent children. Although it is difficult to be precise, it appears that current annual expenditure on Housing Benefit in Scotland is of the order of £1.6-1.8 billion (author calculations).

Benefit cuts and the universal credit

The debate about devolving Housing Benefit's future is not primarily constitutional but rather the result of the dramatic changes to benefits underway as a result of the policies of the UK Government (though politically this has clear constitutional bearing). The Housing Benefit cuts fall into two categories: those that will affect the private rented sector through changes to the Local Housing Allowance (LHA) and those that will impact on housing benefit more generally.

The changes specific to the private rented sector (the LHA) concern:

- Originally planned by the Labour Government, the removal of the £15 excess i.e. tenants will no longer be able to keep the difference or savings made (up to £15) between actual rent paid and the LHA (introduced in April 2011).

- The LHA calculation for eligible rent was changed from deriving the LHA with the 30th rather than the median (50th percentile) of the local rent distribution (introduced in April 2011) – the actual reduction will depend on the distribution of local rents.

- From April 2013, the basis of annual up-rating will change from a proportion of actual market rents to the CPI. Over the past decade private rents have increased faster than general price inflation.

- A cap or maximum was placed on LHA by room size – from April 2011 LHA rates were capped including removing the largest 5 bedroom rate and implying a £400 per week overall cap (i.e. the 4 bed ceiling).

- From April 2012, the coverage of the single room rent for single person household claimants living in private rented housing from under 26 will be

expanded to those up to 35 living alone for new tenants and existing tenants after review.

The other main HB changes that will apply across the rented housing system are:

- Changing the rules for non-dependent deductions, so that previous rent increases are now taken into account effectively increasing non-dependent deductions and thus reducing HB for such households from April 2011. The Scottish Local Government Forum against Poverty (2011) estimates that the cost of fully uprating these deductions back to 2001 will entail an average 27% increase in non-dependent deductions, phased in over three years (p.19).

- From April 2013, HB for working age tenants deemed to be under-occupying based on a standard regional rate for appropriate property sizes.

- There will be a ceiling on all HB from April 2013 between £350-500 depending on household type.

Whilst these changes are introduced, it is the Government's intention that Housing Benefit should disappear among the working age population as it is subsumed within the Universal Credit. This simplification of means-tested assistance for the working age population is intended to confer responsibility on the beneficiary partly through the use of increased conditionality. The Universal Credit will operate on a single taper of 65% of net earnings, along with the retention of earnings disregards. Although the Parliamentary Bill to introduce the Universal Credit is now nearing completion, it is still not clear how housing costs will be dealt with within it.

The Government also intends to end the direct payment of housing-related assistance to (social) landlords. Certainly, the aim of the UC is to provide the tenant with a single integrated payment and the question remains how this might be moderated to help landlords with vulnerable households and those already in arrears (as happens with the LHA). Second, in the long term the DWP anticipates a move from housing support based on actual costs (as with the current way Housing Benefit works) and a move to some form of fixed rate charge (although this might be locally-based, as with the Local Housing Allowance). Certainly, it is hard to see how the Universal Credit can achieve its fundamental goals if Housing Benefit remains separate and detached.

Devolving Housing Benefit 1 (Social Security Reserved)

Alongside the critical political reaction in Scotland to the cuts in Housing Benefit[2], the advent of Universal Credit might well seem like a suitable point at which to devolve Housing Benefit, and to make a 'clean break.' The principal attraction to this approach is that Scotland would be able to design its own housing allowance, and at the least restructure it to be more consistent with or supportive of other housing policies (and welfare policies).

A key risk concerns future budgets for Housing Benefit and, related, the initial settlement of how much Housing Benefit the Scottish Parliament would receive on its devolution. The reform would necessitate a negotiation between Holyrood and Westminster whereby an agreed sum for Housing Benefit would be added to the block grant. The level of Housing Benefit expenditure is the product of the number of claimants and their eligible payments.

The scale of the settlement is absolutely critical as it is a one-off deal that will determine the essential resource level open to the Scottish Government for Housing Benefit thereafter (unless decisions are taken to make use of other Block spending resources). How well Scotland did out of this settlement might be expected to depend on factors such as the point in the economic cycle at which devolution occurred, although this would presumably be taken into account during negotiations, as would any expenditure implications of structural change, such as the shift to up-rating the LHA limit with CPI rather than actual market rents). It would seem somewhat risky to adopt devolution of HB in the hope of successful 'game playing' with the settlement. A much clearer position is required and this may become apparent as a result of the negotiations over Council Tax Benefit, which is being devolved to the Scottish Parliament mirroring 'localism' moves in England.

However, even if a satisfactory settlement were achieved, risks would remain. We noted earlier that while rent rebates are already incorporated into the Spending Block reflecting the need to exert some control over local government rent determinations, overall, the Housing Benefit system reflects considerable demand-led risks. It will inevitably fluctuate in unanticipated ways according to economic change (e.g. unemployment) and demographic change (e.g. household formation and migration). Whilst this is a risk in any form of expenditure, Housing Benefit is much more difficult to control than many other items of expenditure.

What would be the benefits of a devolved Housing Benefit system? In principle Scotland could design its own housing allowance, for example by limiting the scale of the cuts outlined above. But it would do so with no additional resources because this would imply top-slicing resources out of an already highly pressured Scottish Parliament budget and individual programmes within it. This means in turn that a devolved Housing Benefit operating under the reserved social security system with the current level of resources could *redistribute* the value of benefits within its current financial envelope and across current recipients. However, reform to Housing Benefit that involved a substantive redistribution between (potential) recipients would, given the income maintenance role that is fundamental to Housing Benefit, be likely to create some unpalatable choices. For instance, if we recall that the income maintenance role of Housing Benefit is to protect

post housing cost incomes, then it follows that a redistribution in favour of one type of household need will be at the expense of another (because of the fixed global sum available for Housing Benefit).

This is the invidious trade-off and policy bind that any meaningful devolution of Housing Benefit (with the rest of social security remaining reserved) must confront and it is one that applies just as much if a Universal Credit were to be introduced for working age households.

Overall, the devolution of Housing Benefit within the existing constitutional structure therefore represents a very significant transfer of risk to the Scottish Parliament. Legal autonomy over the design of Housing Benefit in these circumstances, given the likely long lasting constraints on overall available resources, would inevitably require unpalatable trade-offs which do not make such a move either likely or desirable.

Devolving Housing Benefit 2 (Devolution Max)

'Devolution max' has not been definitively defined. However, it would clearly require a significant increase in the degree of fiscal autonomy over domestic taxation and expenditure decisions (including elements of social security), whilst Scotland would remain part of the UK. Social protection is the largest single category of UK public expenditure, representing some 30 per cent of the total, so this would mark a very substantial increase in the powers of the Scottish Government.

Such a move would appear to involve a greater transfer of risk to Scotland than the devolution of Housing Benefit alone – simply because of the scale of the budget. However, the disruptive potential of Housing Benefit within this framework would be commensurably smaller for two reasons. First, Housing Benefit would be part of a larger social security budget [for the UK, according to Pawson and Wilcox, 2010, Housing Benefit is about 14-15% of the total UK social security budget including tax credits] so variations in demand for Housing Benefit would have less impact on the total. Second, the revenue base would be much wider, since the Scottish Parliament would presumably have greater borrowing powers (these powers would be required in order to finance cyclical deficits), as well as control over a range of taxes.

Moreover, the potential benefits arising from autonomy is greater than is the case in the devolution of Housing Benefit alone. Within existing budgets, reforms would require trade-offs, but these could be made across a much wider range of benefits and households, and would be unlikely to be as stark as redistribution between housing benefit claimants alone.

The principal attraction of 'devolution max' is that there would exist the potential for a more fundamental reform of housing subsidies, including housing allowances, within the context of a reformed social security system. Whilst involving difficult choices, there would, for example, be the potential to add an allowance for some housing costs into mainstream social security benefits, so allowing the housing allowance to perform more of an affordability role. In turn this would allow the kind of 'shopping incentives' that the Local Housing Allowance sought to attain without such stark trade-offs. So eligible rents need not be based on 100% of actual rents, and households could be expected to carry a proportion of additional housing costs should they choose to consume more housing.

Devolution Max offers the opportunity to move away from the present system, with its ambiguous policy aims and limiting constraints on the design of housing support. Instead the debate could move to the potential to introduce a more recognizable continental social security system that includes a general element of housing support alongside a tailored and more efficient housing allowance based on a standard charge rather necessarily being dependent on actual housing costs. Altering the relationship between social security and Housing Benefit is the only feasible way forward to construct a more functional set of low income personal housing subsidies. Only by Devolving both Housing Benefit alongside the remainder of the social security system would allow such a system to be contemplated.

More radical reforms might include a tenure neutral system, with owner occupiers included in the same scheme as tenants. Whilst this has drawbacks (not least as ownership involves the acquisition of an asset though helping prevent mortgage default can have wider social benefits including stabilizing the housing market), it is a debate that should be had.

While not underestimating the problems of benefit transition (for instance in securing the support of mortgage lenders and those providers exposed to cash flow risks from significant changes to housing benefit), we think that, Devolution Max would also allow the Scottish Government to examine housing subsidies across the system as a whole, with the ability to set both rent policies and demand side subsidies in a way that is frustrated by the current Housing Benefit system's constraining features. It is inconceivable the system could be reformed radically without Devolution Max (unless of course the UK Government took the same route and then this whole debate would be moot).

Conclusion

The debate about devolving Housing Benefit is a multi-dimensional one. At one level, the pursuit of effective housing policies suggests that current Housing Benefit policies are flawed structurally but reform is constrained by the interaction with income maintenance. Devolution Max offers a route to possibly fix some of these important issues. At a second level, the politics of the issue is in part about the Scottish Government's resistance to UK Government cuts and is linked to the overriding constitutional question. In

any case, practical policy implementation of devolved Housing Benefit would take years, with or without Devolution Max. Third, the Devolution Max solution to the Housing Benefit/Income Maintenance integration is also a possible solution for the Universal Credit - incorporating a housing element in the UC plus adding a separate affordability based housing allowance (which could of course be regionally varied). As we hint at above, the same outcomes sought by devolving social security and Housing Benefit in Scotland could be achieved by a willing DWP at the UK level and could be generally consistent with the principles underlying the Universal Credit.

In this short paper we have not been able to cover all of this issues. For instance, we have not touched on the issues that arise if one introduces a substantively different social security system within one (federated) state. How will problems such as benefit tourism and fiscal mobility be addressed? In turn, do Devolution Max and Fiscal Autonomy make independence inevitable?

References

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Endnotes

[1] Thus short paper is based on research for a report for the Chartered Institute of Housing (Scotland) – Devolving Housing Benefit in Scotland. We acknowledge their support and their permission to use material from the larger report in this short paper.

[2] Although there would appear to be little likelihood, after devolution of Housing Benefit, that cuts would be reversed.